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Sept/Oct 1979 AEI Journal on Government and Society

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by Michael Balzano

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"A clear understanding of the li
of what regulation can accom
. . . has the very healthy effec
making an economist-regulat
anxious to seize every possib
opportunity to render regulati
unnecessary."

—Alfred Kahn
November/December 19

"The 1970s . . . constituted a
shed of economic policy, th
ference in the United States
from the new and pervasive
of government and its adve
effects on growth and inflat

—John T. Dunlop
January/February 1979

". . . unless we know *for sure*
the benefits are imaginary,
be a reckless gamble with
lic's health to compel a ban on
diet food products."

—William Havender
March/April 1979

". . . as government regulation .
has expanded . . . , its power ov
religious institutions has becon
considerable. The churches fea
that what is God's is increasing
being rendered unto Caesar."

—Allan Carlson
May/June 1979

". . . cost-benefit analysis is the
enemy of the unbridled agenda
social regulation. . . .

—Suzanne Weaver
July/August 1979

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Regulation

Sept/Oct 1979 AEI Journal on Government and Society

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Letters

PACs

TO THE EDITOR:

In separate articles in your May/June issue, Professor Epstein and Mr. Malbin contend that it is premature to fret about corporate or other kinds of PACs' playing a dominant role in political funding. We at COPE must be way ahead of schedule, for we are concerned *now* —about the PACs of corporations, trade associations, and the "new right wing." We feel they will become one super-PAC, or close to it.

It does not require a consuming case of paranoia to anticipate, as we do, widespread coordination of support to candidates by these kinds of PACs. Already, their representatives join frequently in political and legislative planning sessions.

Their funding potential is enormous. Among them, they ponied up more than $22 million in 1978, more than twice what labor PACs managed to do—with the bulk of it coming from corporate and trade association PACs. This omits the many millions of dollars in small direct contributions generated by the "new right" mailings to vast lists of true believers—which pulled in, for example, $5 million for ultraconservative Senator Jesse Helms and lesser, though still bountiful, amounts for Senators John Tower, Roger Jepsen, William Armstrong, and other right-wing pets.

There is nothing sinister in the fact that corporate, trade association, and right-wing PACs converge behind these candidates: they share common goals. Some of them might stay at arm's length from the more passionate issues of the "new right." But they will all be together—in memory of Millard Fillmore, perhaps—behind candidates sworn to take "big government's shackles" off business and to dump on trade unions and other forces "alien to our shores."

How much will these PACs pump into 1980 campaigns? Given continuing explosive growth in their numbers, and the savvy gained by having a campaign or two under their belts, the sky's the limit. Few eyebrows would be raised—certainly not ours—should their combined contributions in 1980 exceed $75 million....

The AFL-CIO believes in elections, not auctions, for public office. We believe public financing of congressional campaigns makes sense. Epstein and Malbin seem to think this is just labor's sour grapes, suggesting we discovered public financing only after the new toughs moved into the block with more muscular (in terms of aggregate funding) PACs than our own. The writers have not done their homework.

In 1956, when labor PACs practically had a monopoly of the field —except for some trade association committees—AFL-CIO President George Meany urged public financing of all federal campaigns. The federation continues to believe that even a flawed public funding system will be healthier for the electoral process than the wild scramble by PACs to raise and dispense money—and the wilder chase by candidates to get their hands on some of it—that is already well under way.

Ben Albert,
Committee on Political Education

TO THE EDITOR:

The Epstein/Malbin commentaries helped a great deal in setting the record straight about the role of corporate, labor union, and other political action committees in the 1978 congressional elections....

Some observers have erred in the specific portions of nonlabor/nonparty money they attributed to the corporate world. Epstein was careful not to lump this money into the "corporate" category, per se. Yet he may have inadvertently lent support to those who do by his contention that—on the basis of a "very conservative estimate"—half of it came from "business-related" committees. We think that estimate is inflated. Not one of the top ten contributors to candidates in the overly broad category of trade/membership/health groups was a corporate-based PAC. Rather, they all represented doctors, dentists, lawyers, insurance agents, auto dealers, realtors, gun owners, and various "conservative" groups.

The problem may lie in definitions of what is "corporate" or "business" or "business-related." We contend that one ought to distinguish clearly between company PACs per se and other PACs that relate more to trade/professional/membership/health activities.

Epstein referred to the large potential for PAC growth among the 1,500 trade and professional associations headquartered in Washington, D. C. If the laws and regulations were favorable, that large potential might be there. But the legal and regulatory restraints are formidable—especially for those associations whose members are companies rather than individuals. The requirements that these associations obtain permission from their member companies to solicit the executives of these companies and that only one trade association may receive this permission from a given company each year seriously restrict the potential for trade association PACs.

Both Epstein and Malbin refer to the potential for growth in corporate and labor union PAC dollars. Looking to the 80s, the most aggressive efforts to raise funds may not come from the corporate, trade association, and professional groups but rather from labor unions. The United Auto Workers and the Communications Workers of America are discussing with management the possible use of a payroll deduction system to raise dollars for the union PACs. In 1978, the UAW PAC (with about 1.5 million members) spent nearly $1.1 million (about $500,000 more, incidentally, than the combined spending of eleven corporate PACs in the auto/heavy machinery industry). If only half the UAW's members would allow a one-dollar-per-month payroll deduction for a two-year period, that could translate into $18 million in campaign contributions.

BIPAC's studies of the 1978 PAC contributions focused on the 210 of the *Fortune 500* companies that have PACs. In contrast to corporate PACs in general, the PACs of these companies were more interested in challengers and open-seat races than in incumbents. With the exception of House of Representatives' leaders John Rhodes and Jim Wright, who appeared on the list

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of top ten House recipients of all corporate and *Fortune 500* PAC dollars, the results support Malbin's conclusion that corporate PACs are willing to take risks. Not one of the other incumbents receiving the largest contributions from *Fortune 500* corporate PACs won election.

Epstein's observation that business and labor might work together against other forces in the political arena is highly speculative. We note the differences between the candidates supported by labor and those supported by business in 1978 House races. Over ninety candidates for the House received more than $25,000 from union PACs in 1978; fifty candidates for the House received over $25,000 from corporate PACs. Only four candidates were on both lists—two of them being defeated and one elected in a three-way race with less than 50 percent of the vote.

Bernadette A. Budde,
Business-Industry Political Action Committee

TO THE EDITOR:

Edwin Epstein argues that the recent boom in political campaign contributions from business-associated political action committees (PACs) represents an ironic and unanticipated consequence of election reform. In a companion piece, Michael Malbin contends that the substantial increase in PAC campaign giving is nothing to get excited about because it is not a proportional increase when measured against the growth of campaign giving by all other sources.

Epstein, who has spent years documenting the history of the PAC movement, has made an important contribution to our knowledge of the subject. His *Regulation* article, however, misperceives the key legislative battle that opened the door for the explosive growth in the number of PACs, particularly corporate PACs.

The 1974 federal campaign act amendments included a provision that authorized government contractors to establish PACs. This provision overturned a thirty-four-year ban on government contractors' making either direct or indirect campaign contributions to federal candidates. The effort to enact it was led by labor and backed by business. Labor organizations were concerned that, without the change, their government manpower training contracts would make their existing PACs illegal. Business supported the provision because it would enable corporations to establish new PACs.

Epstein cites this effort as one example of how election reform has led to unanticipated consequences—in this case the enormous growth in business-related PACs. . . . But the provision was *not* a reform and its consequences were not unanticipated. Indeed, Common Cause strongly opposed it, *precisely because its potential consequences were obvious.* Senators William Proxmire (D-Wisc.) and Robert Stafford (R-Vt.) led the fight on the Senate floor, but lost 36 to 51. The passage of this "non-reform," along with the defeat of public financing for congressional races, has allowed PACs to flourish in congressional races. In contrast, PACs played a minor role in the 1976 presidential election, which was financed primarily by public funds and smaller private individual contributions.

Malbin's argument—that we have nothing to fear about PACs but fear itself—simply does not hold up. He takes great solace from the finding that PAC giving to congressional candidates in 1978 did not significantly increase over 1976, when viewed as a percent of total funds raised. But the story does not end there, it only begins. PAC giving to congressional candidates nearly tripled between 1974 and 1978, rising from $12.5 million to $35 million. In the same years, PAC funds as a percent of total amounts raised by House candidates also rose substantially, from 18 percent to 25 percent.

PAC contributions have a very special quality. They are most often associated with organized lobbying programs and, unlike most small individual contributions, generally are donations with a purpose. Thus when, for example, the National Automobile Dealers Association increases its donations from $14,000 in 1974 to almost $1 million in 1978, . . . that increase has enormous potential impact on decisions in Congress, regardless of comparative increases in other sources of funds.

The bulk of PAC gifts benefits incumbents, who receive $3 for every $1 that goes to challengers. PAC giving as a percentage of total funds substantially increases when we examine incumbents. In 1978, House incumbents received from PACs approximately 32 percent of the total funds they raised, up from 21 percent in 1974. Of particular concern is the fact that there are 136 members of the House today whose PAC contributions represented more than 40 percent of their campaign receipts in 1978. Also, an examination by the *New York Times* of the most powerful group in the House, the committee chairmen, reveals that PACs accounted for 56 percent of the campaign funds they spent in 1978.

The record shows that PACs already present a clear and present danger to our political system. As for the future, Epstein points out that "the market for potential PAC formation is virtually untapped" by business and that "the 1978 operations of corporate PACs reveal just the tip of the iceberg." Congress should move immediately to reduce substantially the amounts PACs can contribute to congressional candidates, as proposed in a bill introduced by Representatives David Obey (D-Wisc.), Tom Railsback (R-Ill.), Frank Thompson (D-N.J.) and more than 120 other House members. Congress should also extend the public financing concept to congressional races.

Fred Wertheimer,
Common Cause

MICHAEL MALBIN responds:

Fred Wertheimer is correct when he says that PAC contributions were a greater proportion of the total contributions received by House candidates in 1978 than in 1974, but he is wrong in the significance he attaches to the figures.

The proportion of PAC contributions for House candidates has grown steadily from 14 percent in 1972 to 25 percent in 1978, while over those same years, large contributions exceeding $100 dropped from 39 percent to 22 percent of all House contributions. These two figures obviously are interrelated outgrowths of the 1974 law. Before January 1, 1975, individuals were allowed to contribute as much as they wished, but federal contractors could not form PACs. After 1975, individual contributions were limited but PACs were allowed to grow. Since scholars agree that most (not all) large contributors come from the world of business, and since the decline in large individual contributions more than negates the increase from PACs, I still fail to see any reason for the excitement.

Wertheimer should be proud of his role in helping to bring busi-

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ness participation in politics above the table. Instead, he complains because PAC contributions are contributions "with a purpose." Indeed they are, as were most of the large contributions, legal and illegal, of the pre-Watergate years. His unhappiness leads one to suspect that his aim goes beyond that of opening up and cleaning up politics, to creating a world in which people do not try to use politics to achieve private ends—or, at least, not private economic ends. Such a world, alas, is not to be. "If men were angels, no government would be necessary," James Madison reminded us in *Federalist* No. 51.

Madison was no stranger to the idea of "special interests." In *Federalist* No. 10, Madison argued that the best way to avoid the tyranny of a majority faction over a minority—the major danger in a democracy—was to create a modern commercial society in which competing factional interests would flourish. Letting "special interests" participate in politics in an open and limited way is, thus, an essential part of Madison's solution to the problem of democracy.

I agree with Wertheimer that we do not live in a perfectly competitive open-market world; we would probably also agree that the public good does not equal merely the sum of private interests. That is why I support some forms of partial public financing, such as a voucher system, or aid to the parties, that would help enfranchise those people who are too easily overlooked in the present system. But Congress never has been offered a vote on public financing without expenditure limits, and limits—every political scientist who has ever studied the problem agrees—would favor incumbents and hurt challengers. The $50,000 overall limit in the Obey-Railsback amendments would also favor incumbents, although less so than an overall spending limit.

If we truly want to decrease the influence of particular interests, we should listen to Madison and let them be fruitful, multiply, and compete. Increase everyone's resources, and the resources of any one becomes less important. Limiting the PACs will do nothing to help the disenfranchised, and will favor those groups that use other, less accountable, methods to press their political point of view, such as constitutionally protected independent expenditures, "soft-money" spent on registration or getting out the vote, or influence over the media. I find it hard to believe that Fred Wertheimer of all people, or Common Cause of all organizations, would want us to go back to a pre-Watergate world in which the advantage returns to people whose power is not disclosed and is not publicly accountable.

EDWIN M. EPSTEIN responds:

While I am pleased that such thoughtful political practitioners as Ben Albert of COPE, Bernadette A. Budde of BIPAC, and Fred Wertheimer of Common Cause find my analysis persuasive in at least some areas, I consider it important to address items of disagreement.

Ben Albert takes me (and Mr. Malbin) to task for underestimating business-PAC dominance in political funding and for attributing labor's support for public financing to political expediency. First, one point of my article is that the rapid development in the number and size of PACs, *particularly those of a corporate and business-related variety*, warrants our scrutiny in order to ensure that they do not achieve a disproportionately favored position in the electoral process. Therefore, on the question of excessive business influence, I take a "wait and see" approach. Second, I do not doubt there are labor leaders, including AFL-CIO president George Meany, who support public funding on the basis of a principled view of the potential benefits to the electoral process resulting from such financing. However, the enthusiasm and frequency of labor's calls for public funding have increased dramatically during the past few years, particularly since 1976—precisely when labor's position under the FECA and its amendments has most visibly eroded. Principle and interest are frequently well tied together.

Bernadette Budde considers "inflated" my "very conservative estimate" that half of the noncorporate, nonlabor PAC contributions (from cooperatives, trade/membership/health, nonstock corporations, and nonconnected associations) emanate from business-related committees. However, PACs organized by the National Association of Realtors, the National Automobile Dealers Association, the National Association of Life Underwriters, the American Bankers Association, the Chicago Mercantile Exchange, and the National Association of House Builders—each of which were among the leaders in various trade/membership/health categories according to FEC data for Campaign '78—clearly are business related. Indeed, BIPAC (Business-Industry Political Action Committee) itself is registered as a "nonconnected" organization. Moreover, despite the restrictions noted by Ms. Budde, trade association electoral efforts have increased substantially in the past few years and appear likely to grow in the foreseeable future. While she is undoubtedly correct in suggesting that labor will seek aggressively to increase the number of PAC dollars contributed by its members, I am doubtful it will come anywhere near its goal of $1 per member per month. Indeed, both COPE's and UAW's receipts, as well as expenditures and contributions, declined from 1976 to 1978.

True, as Ms. Budde says, corporate PACs were less incumbent-oriented in 1976 than 1978—and so too was labor. I repeat, unions and companies in a given industry may have the same needs (Chrysler and the UAW are today both calling for federal assistance to the former), and thus may well both support the same candidates (irrespective of party or incumbency) who are sympathetic to such needs.

Because Fred Wertheimer and Common Cause have been catalysts in producing the regulatory framework governing federal campaign financing, Wertheimer's criticism warrants careful consideration. He argues, in essence, that the legislative efforts "led by labor and backed by business" to permit corporations and labor unions that were government contractors to establish PACs (an ambiguity in the 1971 FECA) was not a reform effort with unintended and undesired consequences; rather it was really a contra-reform thrust by business and labor, opposed by true reformers such as Common Cause. Yes, some reform groups *did* recognize that the proposed campaign finance laws would benefit the electoral position of certain groups, but it is doubtful that knowledge of this was particularly widespread within the Congress, the press, the informed public or, insofar as it applied to corporate PACs, among labor leaders. The emergence of the business PAC was—and I imagine Wertheimer will agree—neither anticipated nor desired by the large majority of campaign "reformers."

In any event, I thank my critics for their serious and stimulating comments. ■

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Perspectives
on current developments

The Tariff Alternative

Initially one of the least controversial aspects of the Carter administration's new energy program was the establishment of a ceiling on annual oil imports at the 1977 level. Early criticism of the action largely focused on the claim that the ceiling was set too high—given the decline in demand for imported oil over the last two years—to make much of a difference. But now that it looks as if oil imports may bump up against the ceiling sooner than expected, the advisability of a rigid quota is likely to receive closer scrutiny.

The reconsideration might profitably begin with another look at the mandatory quota program used between 1959 and 1973 to protect domestic oil and gas production against much cheaper foreign oil. That program did indeed allow a higher level of domestic production than would otherwise have been possible. But recent studies indicate that it also raised consumer prices more than was necessary and introduced numerous distortions and inefficiencies in the U.S. petroleum industry (see "Readings," p. 56).

There are, in fact, many good reasons why governments usually rely on tariffs, not import quotas, to protect domestic producers. By setting the tariff at a sufficiently high level, the routine level of imports can be reduced almost as surely as under a quota. But a tariff scheme also has the flexibility to accommodate sudden surges of import demand (say, from an unanticipated disruption of domestic production) without the awkwardness of official changes in policy.

In the long run, moreover, a tariff should provide the U.S. government with more economic leverage to contain energy costs than a fixed import quota. Cutting back on our level of imports, whether by quotas or tariffs, cannot in itself force a reduction in OPEC's oil price. The cartel has demonstrated again and again both the willingness and the ability to reduce production in order to keep oil supplies tight in relation to anticipated demand—thus maintaining higher prices even at times when overall demand has declined. In contrast to a tariff, however, a quota would remove existing market incentives that might lead OPEC to moderate its price for the sake of larger sales —since the quota would preclude sales above the given level in any case.

Professor Morris Adelman of MIT, a leading authority on international petroleum economics, has recently suggested that a tariff arrangement could actually be designed to sharpen the market incentives for OPEC to restrain price increases: if a tariff schedule imposed disproportionate increases in import duties for each increase in the original overseas price, foreign producers might find that large price increases cut demand so much as to be unprofitable. At all events, any tariff would return some share of U.S. expenditures on imported oil to the Treasury. A quota scheme, on the other hand, would allow foreign producers to retain all the profit they make in selling oil at the highest price they can get. Finally, just as the quota removes any incentive for foreign producers to moderate prices for the sake of greater market shares, so it also reduces the pressure on domestic producers (those that are or will be decontrolled) to curb their prices—since foreign competition is forcibly prevented from taking any market share above the quota level.

What can be said for the quota, in contrast to the tariff, is that it will have no immediate effect on prices. Until the demand for imported oil actually reaches the specified ceiling, the quota will do nothing to induce shortages (or resulting price increases)—only because it does nothing to restrain imports. At some point, though, rising demand will cause the quota to "bite," and President Carter has announced his intention to lower the quota level gradually

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over the next few years so that it will "bite" more and more deeply as time goes on. For all the reasons enumerated above, the price increases that occur when that happens are likely to be considerably steeper than they would have been under a tariff. Those ultimate increases will be much harder to trace to the government, however, than the price increments imposed by a tariff. For that reason alone, they may be more acceptable to public officials than they should be to consumers.

Last, there will still be the problem of determining who will get access to the limited amount of oil allowed into the country under the quota. In the near term, the quota may produce aggravating oil shortages in the United States, if demand for petroleum products rises at a faster rate than new sources of domestic production. But even after production has caught up, the price of new domestic energy supplies will probably exceed OPEC oil prices for the foreseeable future, so that various sectors of the economy or regions of the country will remain eager for preferred access to imported oil. It was precisely the government's effort to allocate these valuable importation "entitlements" on the basis of (politically articulated) "need"—rather than by the market criterion of readiness to pay—that caused the inefficiencies and distortions associated with the oil import controls in effect between 1959 and 1973.

This time officials at the Department of Energy say they are considering the possibility of simply auctioning import licenses to the highest bidders, thereby retaining some of the efficiencies of a market system and avoiding the need for a cumbersome administrative apparatus to oversee politically determined allocation formulas. But it remains to be seen whether the Carter administration will really be able to bring itself to embrace a market-like mechanism to determine who will be the victims of government-mandated shortage. It could ask Congress to appropriate direct subsidies to particular industries or regions to enable them to bid more readily for scarce imported oil (or to cover the increased costs of purchasing domestic oil). This would be more efficient than trying to assist hardship cases with favored access to imports under an administered allocation scheme. But it would also make the costs of the quota program more visible—whereas its main advantage seems to be in concealing costs. Further developments on this side of the quota program should be awaited with interest, then, if not quite with optimism.

Mobilizing the Energy Regulators

Certainly the most novel element in the administration's energy plan is the call for an "energy mobilization board" to speed regulatory decisions affecting new energy projects. Such a radical departure from traditional practice is an implicit confession of serious regulatory failings in the past. But whether the mobilization board is really the proper sentence to pass on the guilty parties remains to be seen. We might do better to examine the confession itself.

In his July 15 television address, President Carter suggested that the delays and roadblocks encountered by new energy projects have largely been the product of unnecessary "red tape." He gave an emphatic assurance that "we will protect our environment"—evidently with undiminished rigor—but also declared that "when this nation critically needs a refinery or a pipeline, we will build it." Accordingly, the White House proposal states that the energy mobilization board will only be authorized to "eliminate or modify *procedural* impediments" (emphasis added) to the construction of major new energy facilities "without altering substantive Federal, state or local standards."

But where some people see unnecessary red tape, others see essential safeguards against high-handed, reckless, or unaccountable decision-making by government regulators. Procedures, after all, are usually designed to ensure —or to prevent—certain *substantive* outcomes in administrative deliberations. Thus the mobilization board will be authorized to set deadlines for the consideration of new projects by the many agencies charged with monitoring health, safety, and environmental standards and, in certain cases, to order particular streamlined or modified procedures to save time. At the least, this presumes that the board could judge how much consideration was needed in each case better than the specialized monitoring agencies themselves. Is it altogether unreasonable for environmentalists to fear that under modified or accelerated proceedings, reg-

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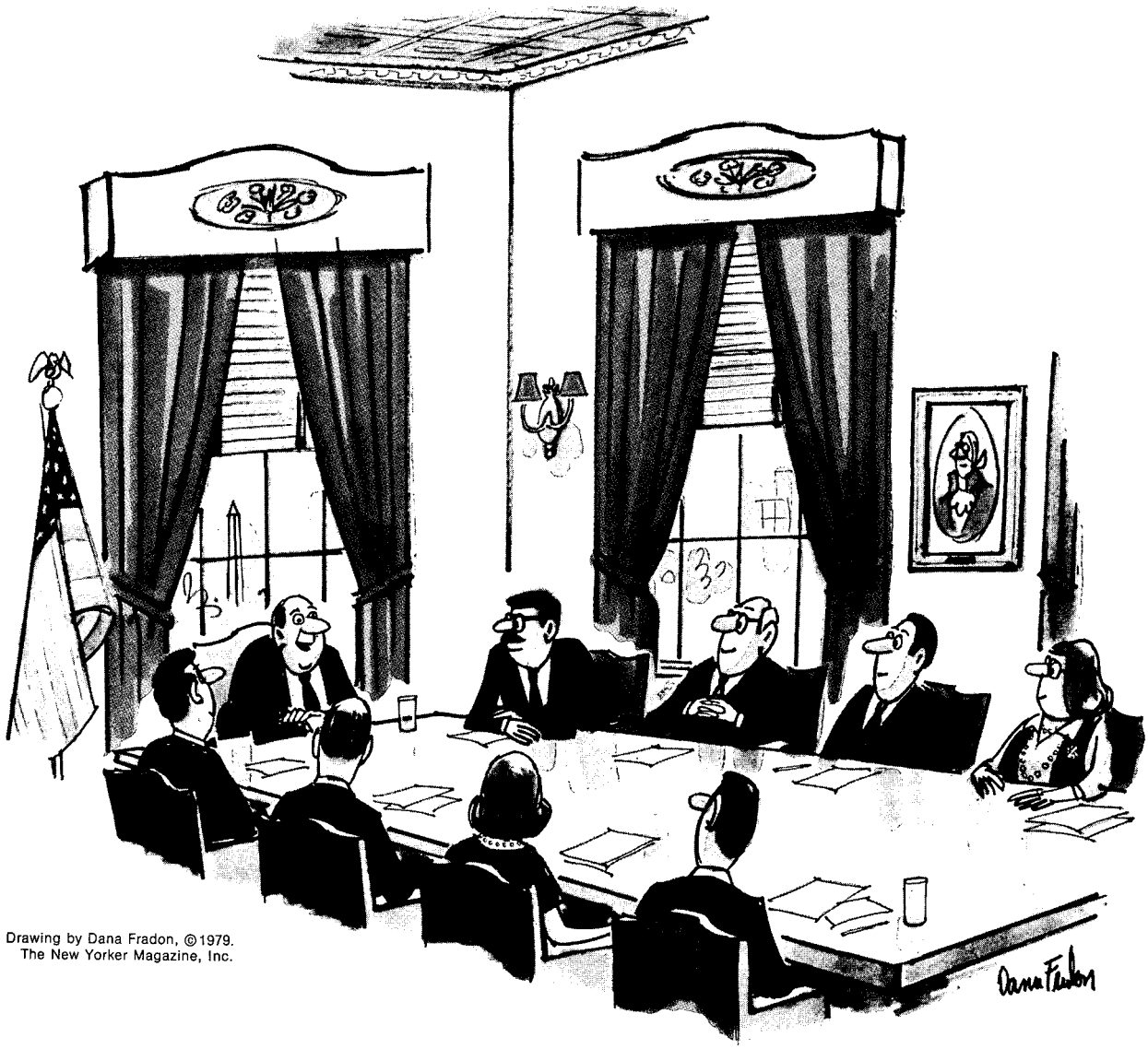

"Then we're all agreed. As it has always done with its difficulties in the past, America will somehow find a way to solve its energy problems."

ulators would not be able to consider all the safety and environmental risks of a new project as thoroughly as they have been accustomed to do? The Carter administration itself seems to concede something to this concern in explicitly exempting nuclear facilities—where public fears of inadequate regulatory supervision are perhaps at their highest—from the mobilization board's jurisdiction. And yet the delays in securing construction and operating permits have been longer and costlier in the case of nuclear plants than for almost any other type of energy facility.

It might be wiser, after all, for the administration to concede that a speed-up in the development of new energy facilities may require some changes in the substance as well as the procedures of existing regulation. Several congressional versions of the mobilization board proposal would authorize the board to order easing or modification of regulatory standards for particular facilities under certain circumstances. Even the administration's proposal would allow the board to waive regulatory requirements imposed on a new facility after its construction had begun. In failing to extend this authority more broadly, the administration's proposal runs the risk of promoting a larger number of regulatory vetoes than at present: agencies with inadequate time to re-

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solve all their doubts about a new project may simply decide to prohibit it. But it is not even certain that authority over procedural standards would produce speedier decisions, since it is likely to provoke a good deal of time-consuming litigation challenging mobilization board judgments about the ambiguous line between "procedural" and "substantive" standards. In reducing the scope or modifying the techniques of a mandated environmental impact study in a particular way, for example, would the board have introduced a substantive or a merely procedural change in existing requirements? The courts may be at work for some time resolving questions of that sort.

With sympathy from the courts and the relevant regulatory bodies, however, the energy mobilization board might still accomplish a great deal. And while a reconsideration of overly severe substantive standards might be more generally helpful, it is easy to conceive that, in some areas, a consolidation of the separate proceedings often now required by many different agencies with overlapping jurisdictions would speed project approvals without affecting substantive standards.

However, that still leaves at least one important question to ponder. If such a boon can be achieved at so little cost to regulatory standards, why limit it to only seventy-five new projects at a time, as the administration proposes (or to fewer than twenty-five as several congressional versions provide)? A systematic reorganization of regulatory procedures for energy projects would doubtless take longer than the establishment of an emergency mobilization board—but it would not have to be sustained by the overused rhetoric of an energy "crisis." We might even find it possible, in that case, to bestow this benefit on firms or institutions that claim no energy tie-in, but feel just as oppressed by costly, repetitive regulation.

Letting the Buses Run Free

Although most airlines resisted deregulation—and the trucking industry is now fighting it bitterly—much of the initial impetus for deregulation of intercity busing came from within the industry itself. Trailways has recently backed away from its earlier enthusiasm for deregulation, but given the tendencies already evident in the Carter administration and the Interstate Commerce Commission, the bus industry may still turn out to be the next stop for the deregulation movement.

There are more than 1,000 firms providing intercity passenger bus service in the United States, but Greyhound and Trailways enjoy unchallenged dominance. Greyhound collects about 60 percent of the industry's revenues from scheduled service, Trailways about 20 percent, and the next largest company a mere 2 percent. The distribution of market shares has remained much the same since the 1930s, when Congress gave the ICC responsibility to regulate interstate bus routes and fares. This "freezing" of the industry has been due not only to ICC regulation but also to various state regulatory commissions that have restricted competition in intrastate markets. Indeed, it is the official policy of Arizona, California, and several other states to allow no more than one bus company to serve each intrastate route.

Trailways initiated the current debate over deregulation in an effort to expand its traditional markets. Trailways and the bus industry in general have suffered substantial declines in profitability since the early 1970s. Price increases approved by the federal and state regulators have lagged behind increases in the costs of labor, new buses, and fuel. Furthermore, bus companies have lost passengers to other forms of transportation—to the airlines (whose Super-Saver and other discount fares have actually made it cheaper to fly than ride the bus on some routes), to Amtrak (which gets two-thirds of its revenues from federal subsidy), and to the private automobile. Between 1970 and 1977, passenger-miles on intercity buses grew only 1.5 percent and before-tax profits declined 37 percent (from $89 million on revenues of $901 million to $56 million on revenues of $1,303 million).

Trailways' efforts to expand have been hindered by lack of both route authority and pricing flexibility. Acquiring new interstate or intrastate route authority is a slow and expensive process. Applications are almost invariably contested by carriers already serving those routes and approval, if it comes, is generally preceded by many months or even years of delay. Raising or lowering fares is not much easier. A carrier must give public notice well in advance of any fare change, and the proposal

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may very well be blocked—or at least delayed—by complaints from rival carriers. Not only may the rival's interest in preserving his profitability be the motivation for a complaint, but it may be the formal basis for the complaint—namely, that a fare reduction will divert so much business as to injure him financially.

Trailways has thus found it extremely difficult to enter new routes now served on a monopoly basis by other carriers or to offer discount fares—in imitation of the airlines—to lure passengers from competing services. The company finally concluded that it would do better to press for systematic relaxation of regulatory constraints than to fight through its numerous new route and fare applications on an exhausting case-by-case basis. In July 1978, it petitioned the ICC to permit bus companies to cut their fares without advance notice and, in the ensuing months, it petitioned the ICC for liberalization rules on fare increases and new route entries. Last November, the company escalated its campaign, when Trailways President J. Kevin Murphy, in a speech to the National Association of Regulatory Utility Commissioners, urged Congress to consider total deregulation of the industry.

Greyhound opposes the "piecemeal deregulation" embodied in Trailways' petitions to the ICC but has supported the concept of total deregulation since last February. Like Trailways, Greyhound has been alarmed by the industry's recent financial decline. However, it is far less interested in expanding its already huge market share than in being free to raise prices and to abandon unprofitable routes. To obtain these freedoms, it is willing to sacrifice the anticompetitive protection that entry controls and price floors provide. But it strenuously opposes the idea of having price floors and entry controls removed while price ceilings and route abandonment controls remain intact.

As with airline deregulation and trucking deregulation, one of the key issues in the busing deregulation debate is that of small-community service. Intercity buses are the principal provider of intercity transportation for rural America, serving 15,000 communities, of which 14,000 have neither air nor train service. Opponents of deregulation argue that deregulation would cause hundreds or even thousands of these small communities to lose their bus service. But supporters respond that existing small-community service is potentially far more profitable than opponents acknowledge and therefore would not be seriously threatened by deregulation. Furthermore, they argue that this service could be maintained more equitably and efficiently through federally or locally funded subsidies paid directly to low-bid contractors than through regulation-enforced cross subsidies.

The other key issue, also reminiscent of airline and trucking deregulation, involves the industry's ability to sustain healthy competition. Deregulation opponents claim that ending controls would enable Greyhound and Trailways to bankrupt or absorb their smaller rivals and that the resulting oligopoly would sooner or later push prices higher. Supporters insist, however, that deregulation would make the industry more competitive and innovative. They point out that, because economies of scale are negligible in the industry and because the investment required to start or expand business are low (a new Greyhound Americruiser costs about $100,000 and a decent used bus about $25,000), small new firms would not necessarily be at a disadvantage. Lacking the protection of entry controls and price floors, any carrier charging excessive prices or providing substandard service would lose business to rivals. Enforcement of existing antitrust laws by the Justice Department should be sufficient to ensure that the industry giants cannot drive out new rivals by taking profits from "monopoly" routes to support below-margin pricing in the newly competitive routes. Thus, even if Greyhound and Trailways increase their market dominance under deregulation, they would risk losing their market power if they abused it.

Trailways, however, has recently begun to have second thoughts about this part of the case for deregulation. This summer, right after the Holiday Inn conglomerate sold the company to independent operators, the new management (which includes several officials previously associated with Greyhound) expressed the view that deregulation was impractical for an industry so dominated by one company. In late August Trailways withdrew its petition for more flexible route entry provisions and subsequently modified the proposals it had submitted to the ICC on fare flexibility.

The ICC is free to put through liberalization measures at its own initiative, however,

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and with the appointment this summer of three new commissioners known to be sympathetic to the relaxation of motor carrier controls, it may wind up doing precisely that. President Carter, himself, endorsed deregulation of interstate bus operations in his budget message last January. Since then, a task force at the Department of Transportation has been studying the industry and developing legislative proposals, which the administration may submit to Congress this fall. Now that Trailways has reversed its position, Congress is unlikely to show much interest in the issue before the 1980 elections. But if the ICC presses ahead with liberalization measures and gets good results, the groups supporting comprehensive deregulation in Congress can be expected to grow.

Who's in Charge Here?

"Who decides?" may be the central question in evaluating any political or administrative scheme. If so, the Carter administration's Regulatory Analysis Review Group, as well as its regulatory reform bill and most of the parallel bills on regulatory procedure introduced in this session of Congress, all miss the point where federal regulation is concerned. Now the American Bar Association has not only asked the central question but is proposing a decisive answer: at its meeting this summer in New Orleans, the ABA's House of Delegates approved a resolution calling on Congress to pass legislation affirming the President's authority to redirect or, if necessary, overrule the decisions of all regulatory agencies (even the so-called independents) on new regulations.

The ABA's action grew out of a report by its Commission on Law and the Economy, a group of twenty-six lawyers and economists organized by the ABA in 1975 to study ways of improving government regulation. This commission conducted three years of research and investigation (funded with over $500,000 in grants from private foundations and the ABA) before issuing its report last year, entitled *Federal Regulation: Roads to Reform.* The recommendations on presidential authority are contained in a section of the report prepared by the commission's Committee on Regulatory Accountability, chaired by Lloyd Cutler, a prominent Washington attorney who now serves as an advisor to President Carter. Perhaps anticipating that these recommendations were more controversial than those in other sections of the commission's report, the ABA's House of Delegates left them until last, finally endorsing them by a voice vote on July 14.

The ABA's report is hardly the first outside study to call for greater presidential control over the regulatory agencies. As far back as 1937, President Roosevelt's Committee on Administrative Management urged that the independent regulatory agencies be brought under the President's supervision to ensure their accountability to the one political authority elected by the whole nation. Ten years later, the Hoover Commission on Reorganization of the Executive Branch decried the proliferation of independent regulatory bodies as creating a "headless fourth branch of government," not adequately accountable to any elected authority. But Congress, which conferred independent status on these agencies essentially to keep them out of the President's hands, has repeatedly rebelled at proposals to centralize regulatory authority in the White House. In recent years, even the President's authority to control decisions of the other agencies, those formally included in the executive branch, has come under fire in Congress (see "The Politics of RARG," *Regulation,* July/August).

The ABA commission does not take sides in the current legal controversy about the actual scope of presidential authority over executive branch agencies conferred by the Constitution or existing laws. But the commission does make a strong argument, on policy grounds, for enacting a law that clearly establishes the President's ultimate review authority over new federal regulations, regardless of where they originate or how the originating agency is formally classified. The strength of the argument is that it focuses less on the issue of political accountability in the abstract than on the practical problem of coordination or balance among competing regulatory objectives.

The report points out, for example, that regulatory authority over issues bearing directly on the price and availability of energy supply is still scattered among fourteen different agencies, each with its own governing statutes and policy priorities, *in addition to* the array of regulatory authorities sheltered under

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In Brief–

Skating Free. On August 22, the Consumer Products Safety Commission officially rejected a petition to ban skateboards. The petition, filed ten months earlier by the Americans for Democratic Action, claimed that skateboard designs could not be improved to make them safe. In rejecting the petition, the CPSC noted that injuries associated with skateboards had fallen from 140,000 in 1977 to 87,000 in 1978. It also noted that while the declining popularity of the sport may have had something to do with the declining injury rate, wider use of safety precautions may have been a greater factor (spurred, in part perhaps, by a CPSC-supported safety advertising campaign). In this case, safety precautions seem to have been adopted without new regulatory requirements.

A High-Water Mark for Energy Policy. In a July 1979 report to the Council on Environmental Quality, scientists from Woods Hole, Dartmouth, University of California at San Diego, and Scripps make the interesting point that synthetic liquid or gaseous fuels made from coal release, when burned, an average of 1.7 times the amount of carbon dioxide (CO_2) released by the direct burning of oil, coal, or natural gas. CO_2 absorbs infrared radiation, thus producing an increase in the earth's temperature—concentrated, as it happens, in the polar areas. This will melt the polar ice, which (if it occurs on a large enough scale) will in turn raise sea levels worldwide—perhaps by as much as twenty feet, sinking most coastal cities beneath the waves. The authors of the report conclude, mildly enough, that this circumstance "requires consideration of the CO_2 problem as an intrinsic part of any proposed policy on energy."

Sears Still at It. Contrary to earlier press reports—including an "In Brief" item in the July/August *Regulation*—the Equal Employment Opportunity Commission has not taken its charges against Sears, Roebuck and Co. to federal court. The commission did vote in mid-July to authorize its staff to bring suit against Sears for employment discrimination, but staff memos subsequently leaked to the press indicate that at least some members of the staff do not believe the case would stand up in court. Meanwhile, attorneys for the giant retailer say the company will press ahead with the appeal of its own suit against EEOC and nine other federal agencies (a suit dismissed without hearing by the federal district court in Washington last May 15), even if EEOC agrees to take no formal action against Sears.

Helping Hand. The Emergency School Aid Act, designed to assist school districts in bearing the costs of implementing school desegregation plans, also makes grants to local television stations to encourage the "development and production of integrated children's programming of cognitive and effective value." On August 20, the Department of Health, Education, and Welfare announced that, in deciding whether a station should receive a grant, it would consider the extent to which the station employs "minority group persons" in "key creative, administrative and executive decision-making positions." In a published statement, Assistant Secretary Mary Berry denied that the new rule "will lead to the promotion of unqualified people." Rather it "will provide a competitive advantage to proposers who employ qualified minority group members in positions where they may help ensure that the background and culture of minority groups are reflected in ESAA television programs." She did not elaborate.

Bumpers Standards. An amendment to the Administrative Procedure Act, sponsored by Senator Bumpers (Democrat, Arkansas) and nine colleagues, passed the Senate on September 7. It includes the following:

"To the extent necessary to decision and when presented, the reviewing court shall decide all relevant questions of law, interpret constitutional and statutory provisions, and determine meaning or applicability of the terms of the agency action. *There shall be no presumption that any rule or regulation of any agency is valid,* and whenever the validity of any such rule or regulation is drawn in question in any court of the United States or any state, the court shall not uphold the validity of any such challenged rule or regulation unless such validity is established by a preponderance of the evidence shown." (Emphasis ours.)

There is good news and bad news. First the good news: this provision would weaken the authority of the agencies to fill in the blanks in broadly worded statutes with their own notions of appropriate policy. Now the bad news: that authority lost by the agencies would be conferred upon the courts.

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the new Department of Energy. The coordination problem is particularly acute, according to the report, because most agencies have been given rather specialized functions or responsibilities and each tends to regard its "own mission as having importance at least equal to that of all other government goals." And even with the benefit of extensive interagency consultations (which the commission also recommends in its report), single-mission agencies are poorly equipped to make major balancing judgments among competing national policies —when the goal of curbing pollution, for example, conflicts with the goal of curbing inflation or of stimulating domestic energy production. In cases like these, "only elected officials

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and their immediate staffs can provide the requisite overview and coordination, make practical political judgments that weigh competing claims and stand accountable at the polls for the results." The report argues that Congress "cannot perform these tasks by legislating the details of one regulatory decision after another"—if it could, it would not have "delegated power to the agencies in the first place"—so the initiative must fall to the President.

Specifically, the commission proposes a general statute authorizing the President

> (a) to direct any regulatory agency to take up, decide, or reconsider a critical regulatory issue within a specified period of time, and (b) thereafter to modify or reverse an agency policy, rule, regulation or decision relating to such an issue.

The statute would exempt from this authority agency "adjudications," such as issuance or revocation of licenses to particular firms or the issuance of "cease and desist" orders or penalties in the enforcement of existing regulations. It would also exempt the money market functions of the Federal Reserve Board, the campaign financing functions of the Federal Election Commission, and a few noneconomic regulatory issues on which there is "still a broad consensus that they are better left entirely in independent hands" (the fairness doctrines of the Federal Communications Commission being the only example cited). The ABA's proposal would not empower the President to direct an agency to do anything that it would not otherwise be authorized to do and would afford judicial review of all such presidential orders.

The ABA proposal incorporates numerous procedural safeguards. It would require the President to publish in the *Federal Register* advance notice of his intention to issue any order of this kind, to allow a thirty-day public comment period on the proposed order and then, if the order is adopted, to publish along with it the factual findings and policy considerations underlying it. Finally, though the commission expresses doubts about the constitutional propriety of a legislative veto, it urges that such presidential orders to the regulatory commissions not take effect until seventy days after their promulgation. This would give Congress time to overrule the President's decision by legislation—or the President an opportunity to modify or withdraw an order that meets with a particularly hostile congressional reception. The commission also recommends that the legislation granting these powers to the President be limited to a specified term, so that Congress could refuse to renew it if it decided the new powers were being widely abused.

Even with these safeguards, the ABA proposal is sweeping in its implications and sure to raise hackles in many quarters. Several members of the ABA commission itself warned

- that the proposal could "politicize agency decision-making" (though the proponents would presumably reply that the priority decisions to be made are inherently political);
- that it would replace careful administrative judgments with the assessments of uninformed and inexperienced White House staffers (an argument that would have more force if, under the proposed statutory scheme, the President's personal responsibility were not so visible that his concern for political self-preservation would lead him to consult all knowledgeable sources, including the expert agencies); and
- that the proposal would usurp the rightful authority of Congress to establish priorities among competing national policies—an objection that is sure to be echoed in Congress itself (though it can be answered with the claim that congressional failure to exercise such authority in the past is precisely what renders the scheme necessary and that the seventy-day waiting period provides ample time for Congress to block presidential initiatives in this area it does not like).

At any event, it is not clear that any President would really welcome such comprehensive responsibility for the management of regulatory affairs. It may be significant in this connection that the White House has not yet responded publicly to the ABA proposal. Thus while the main elements of the proposal have recently been incorporated in a bill by Senator William Roth (Republican, Delaware), its fate remains most uncertain. At the least, though, the ABA's recommendations should help to focus the debate on regulatory reform on one of the central issues of regulatory management.

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Viewpoint

Kenneth J. Arrow and Joseph P. Kalt

Why Oil Prices Should Be Decontrolled

POLICY-MAKERS CURRENTLY face major decisions on petroleum pricing and have an important opportunity to rethink the direction of U.S. energy policy. Present oil price control regulations are scheduled to expire in October 1981; and in June 1979 the Carter administration began to phase out price ceilings so as to bring about a gradual transition to decontrol. It remains to be seen whether Congress will block gradual decontrol and extend price regulation past 1981. Nevertheless, if these decisions are to be made rationally, policy-makers must be clear on the issues involved.

There are two basic kinds of issues raised by the prospect of decontrol. Because federal price regulation forbids crude oil producers from selling their output at market prices and because it forestalls much of the prospective transfer of wealth from domestic users to domestic producers portended by the rising world oil prices of the 1970s, issues of fairness (or equity) arise in the debate over policy. And because the constraints placed on this prospective transfer themselves distort energy use and production decisions, issues of efficiency inevitably arise as well.

Oil price regulations in fact impose a net efficiency loss on the U.S. economy. Consequently, the crucial question is whether the gains in efficiency from decontrol outweigh any equity losses. On the basis of explicit measurement and comparison, we conclude that the answer to this question is yes. Oil prices should be decontrolled.

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The Costs of Controls

Demand-Side Inefficiency. Domestic crude oil price controls prevent much of the increase in the wealth of crude oil producers that would accompany an increase in domestic prices to world levels. An estimate of this potential wealth increase can be found by calculating the difference between the revenues that would be generated in the absence of controls and the actual revenues on controlled output. Assuming that domestic regulation has had no effect on the "uncontrolled" world price for crude oil, these "transfers" were running at a pace of roughly $17 billion in May 1979 (that is, immediately before the administration's first gradual steps toward decontrol). These billions of dollars represent a windfall to *users* of crude oil—including large refiners, small refiners, and ultimate consumers, both industrial and individual. The division of the windfall among these groups depends on the impact of a complicated set of regulations called entitlements.

Obviously, the prospect of any transfer of $17 billion a year would induce interest-group competition. The entitlements program is an outcome of such competition and is the mechanism that determines the eventual ownership of the windfall gains arising under crude oil price controls. Essentially, the program taxes away these gains and redistributes them as subsidies for the expansion of refinery output. Since the supplies of crude oil available for such expansion primarily consist of imported oil, the entitlements program subsidizes the use of foreign oil. This subsidy, which varies with the gap between the world price of oil and the domestic weighted average price, averaged $2.35 per barrel over 1975–78 and was $2.44 in May 1979.

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Now, as far as the nation's economy is concerned, efficient use of crude oil requires that the price paid by the nation to acquire a barrel of crude oil not exceed the value consumers place on the contribution of that crude oil to the refined products they desire. The present inefficiency arises because, with the entitlements subsidy, refiners see the cost of crude oil to themselves as something less than the amount actually paid to foreign suppliers. Consequently, they use too much crude oil—too much in the sense that the country hands over resources to foreign oil sellers which are more valuable than the goods produced by having additional crude oil for refining. Assuming (as the evidence suggests) a 1 percent reduction in the price of crude oil induces refiners to increase use of crude oil by one-half of 1 percent within the year of the price reduction, then (based on May 1979 data) domestic refiners use about 375 million extra barrels of imported crude oil per year as a result of the entitlements subsidy—though, of course, these entitlements-induced expenditures produce goods of some value to the intermediate and ultimate consumers of crude oil. Our calculations show a gain of $13.2 billion a year to crude oil users, at a cost of $13.7 billion a year. The net loss—in demand-side efficiency—is thus $500 million a year.

Supply-Side Inefficiency. Federal regulation of domestic petroleum prices not only induces overconsumption of crude oil in the United States. It also causes underproduction, and this results in a net loss to the economy.

Efficiency in crude oil production requires that, for a given level of demand, the total cost of acquiring oil from both foreign and domestic sources be as low as possible. When the alternative to domestic oil is imported oil bought at the world price, efficiency requires the production of all domestic crude oil that can be had at a cost not exceeding the price of foreign oil. If the cost of an incremental unit of output of domestic oil is greater than the price of imported oil, the nation could save by replacing domestic output with imported oil. Conversely, if the cost of an incremental unit of output of domestic oil is less than the price of imported oil, we would save by importing less and producing more. It makes little sense to hand over, say, $19 to foreign oil producers for a barrel of crude oil if a comparable barrel can be acquired domestically for, say, $13.

. . . the crucial question is whether the gains in efficiency from decontrol outweigh any equity losses. . . . we conclude that the answer to this question is yes.

Federal price controls violate the criteria for efficiency in oil production. Ceilings on the prices that can be paid for so-called lower- and upper-tier crude oil discourage producers from taking full advantage of sources of supply with production costs greater than those ceilings—even though there are, among these, sources that could produce oil at a cost below the price of imported oil.

What are the supply-side costs of crude oil price controls? Assuming (somewhat conservatively) that a 1 percent increase in price causes a one-tenth of 1 percent increase in production from existing wells, the cost of discouraging production from existing supply sources is about $800 million a year. Assuming that production from newly developed wells shows a one-half of a percent increase in response to a 1 percent increase in price, the cost of discouraging the development of new supply sources is about $1.2 billion.

The total $2 billion estimate of the annual supply-side costs of controls is likely to be an underestimate if price controls have increased the uncertainty of investors who develop new supply sources. Though newly producing oil properties qualify for upper-tier prices today, there is no guarantee they will tomorrow. Indeed, since 1971, domestic crude oil prices have been subject to no less than eight pricing schemes. If the developers of new supply sources expect to be able to sell their output at the *average* domestic price (about $11) rather than the upper-tier price (about $13), the supply-side costs are on the order of $4 billion a year.

The supply-side costs of controls are also likely to be underestimated—as are the demand-side costs—if there are unmeasured costs of overdependence on foreign crude oil that petroleum users do not take into account when buying on world markets. Such costs—from the threats to national security or macroeco-

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nomic stability posed by import dependence—make the real cost of each barrel of imported oil higher than the real price paid on world markets. A $1.00 per barrel "overdependence" cost would raise the sum of the annual supply- and demand-side efficiency costs by more than $1 billion.

To summarize, even if we do not complicate things with considerations of investor uncertainty or import overdependence, the sum of the supply-side costs ($2 billion) and the demand-side costs ($0.5 billion) of petroleum price controls appears to be at least $2.5 billion a year. Inclusion of the complications which have been mentioned could double this estimate. And this is not all.

Other Costs. Private-sector costs of carrying out the administrative duties and obligations created by current regulations may be as much as $500 million annually, not counting the costs created by regulatory distortions in business transactions and competitive behavior. The *federal* administrative burden of regulation (paid for, of course, by the taxpayers) may be approaching $200 million annually. More subtle costs arise from the unambiguous support given OPEC by discouraging domestic production and subsidizing imports. And, finally, the inflexibility and inefficiency of current policies magnify the difficulties of adjusting to sudden shocks in world energy prices and supplies.

Winners and Losers under Controls

Recognition of the costs of controls is not in itself a sufficient base for major policy change. While removing the controls would avoid current inefficiencies, it would also have unavoidable "distributional" consequences—that is, it would redistribute income among the citizens of the United States. This raises the issue of fairness (or equity).

The windfall gains that accrue to crude oil producers as a result of rising oil prices are windfall losses to crude oil consumers. Of course, petroleum may be consumed either directly or indirectly. While automobile drivers and homeowners, for example, are direct consumers of gasoline and heating oil, they are by no means the only consumers adversely affected by higher oil prices. Industrial, commercial, and transportation-sector buyers of energy also face higher oil prices, which raise production costs and thus raise prices of goods and services or reduce stockholder wealth in these sectors.

The burden of rising prices on the users of petroleum induces reductions in the "energy-intensiveness" of production processes and consumption patterns. Firms, industries, and sectors of the economy most able to make these reductions over time enjoy relative competitive advantages. Final consumers most able to make such reductions find their real incomes relatively less vulnerable to erosion. Indeed, over the long run, the severest burden of rising energy prices must fall on those users whose behavior is least responsive to price changes. This is particularly pertinent to one group—crude oil refiners.

Reduction of consumer demand in response to rising oil prices tends to leave current refining capacity underutilized and to discourage industry expansion. Moreover, the depressing effect of rising prices on the quantity of petroleum products demanded tends to prevent the industry from passing on to consumers the full amount of any crude oil price increases. These effects decrease the value of refiners' assets. Thus, much of the burden of crude oil price increases rests on the owners (stockholders) of oil refineries rather than on final consumers.

Needless to say, the users of crude oil, whether refiners or consumers, do not welcome increases in oil prices. It is to be expected that they will use whatever political influence they have to prevent, forestall, or otherwise avoid the distributional effects of those increases. The ensuing political struggle should not, however, be naively represented as a contest between "consumers" and "the oil companies"—an oversimplification that ignores the fundamental divergence of interests between oil companies that are primarily refiners and oil companies that are primarily crude oil producers. While raising the specter of a monolithic oil lobby has value as a tactic of political debate, it obscures the more subtle reality.

The removal of crude oil price controls would benefit producers by about $19 billion annually. Of this, $17 billion would arise from the ability to sell current production levels at world prices and $2 billion would arise as a net

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gain on the additional output induced by decontrol (that is, from the removal of the supply-side inefficiency). Of the $17 billion withheld from producers on currently controlled oil, $3.3 billion is used to fund such special programs as the grants made under the Small Refiner Bias, $13.2 billion goes to crude oil users through the entitlements subsidy, and $0.5 billion (as we saw in our discussion of demand-side inefficiency) is wasted. Crude oil users include both refiners and consumers, and their division of the $13.2 billion transfer is not self-evident. Since the entitlements subsidy lowers (incremental) refining costs and encourages an expansion of the domestic refining industry, it therefore lowers the price of refined petroleum products —but not by the full amount of the entitlements transfer.

The upward pressure of refinery expansion on production costs other than crude oil costs and the negative relationship between price and demand for petroleum products prevent a full pass-through. The most generous assumption we can make without being totally at odds with available evidence is that approximately 55 percent of the entitlements subsidy is passed through to consumers. At 55 percent, consumers capture approximately $7.3 billion. Refiners retain $5.9 billion. When the impacts of special programs such as the grants to small refiners are added to those of the entitlements subsidy, the net gains of consumers and refiners are approximately $8 billion and $8.5 billion a year, respectively.

Fairness and Decontrol

If we believe any efficiency-improving policy change is fair, then obviously decontrol should be supported. And if we believe that voluntarism in exchange—that is, the freedom of the individual—is the relevant criterion for fairness (or equity), we should also support decontrol.

These views of fairness, however, seem to be side issues in the current debate where the most commonly invoked notion of equity concerns the effects of decontrol on the poor. Other things being equal, it is taken as given in the debate that a more equal distribution of income is better than a less equal distribution of income.

The egalitarian policy-maker who is concerned about the distribution of income and who would like to redistribute toward the lower end of the income scale faces a trade-off between fairness and efficiency. This trade-off arises because the implicit or explicit taxes on the rich (or "non-poor") needed to accomplish a redistribution tend to discourage income-generating investment and employment. A policy that redistributes income downward, but reduces the size of the total economic pie (so that the amount taken from the rich is greater than the amount delivered to the poor), should be supported only if the value assigned by the policy-maker to the dollars transferred to the poor exceeds the value assigned by the policy-maker to the dollars lost by the rich.

To make this sort of comparison, a decision must be made as to how much weight should be given to rich and poor. In our calculations here, we have assumed that the contribution of an extra dollar of income to the well-being of the recipient is inversely proportional to the recipient's present income. Thus, for example, it would be half as worthwhile to give a dollar to someone earning $20,000 a year as to someone earning $10,000. In keeping with available evidence, we have assumed that the consumption of energy is roughly proportional to income. We have also assumed that dollar transfers to or from industries are transfers to or from the stockholders of those industries. Consequently, redistributions among industries have no effect on fairness, the position of stockholders in the income distribution tending to be much the same from industry to industry.

The key empirical fact in analyzing the fairness of decontrol is that the distribution of stock ownership is very different from the distribution of income. If indeed, as we assume, the stockholders in petroleum-related companies are much like stockholders in general, then the percentage of stock held (by market value) in such companies varies positively with family income. In fact, given our weighting system, the distribution of stockholders implies that a dollar given to a typical petroleum product consumer has roughly twice the "equity value" of a dollar given to a typical stockholder in a crude oil producing firm. Thus, decontrol would certainly have a reverse Robin Hood effect: it would take from those whose income is weighted relatively heavily and give to those

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whose income is weighted relatively lightly.

As noted, about $8 billion would be transferred from users of petroleum products to stockholders of crude oil producing companies. Part of this $8 billion, of course, is a transfer from some corporations (for example, industrial users) to other corporations (producers). We estimate that the intercorporate transfer is about $0.6 billion, leaving a net consumer-to-producer transfer of $7.4 billion. Of this, 48 percent is taken back by taxes (federal income, state income, and severance). If these tax revenues produce benefits which, like energy consumption, are approximately proportional to income, a net transfer of $3.8 billion remains. Thus, with crude oil producers given only half of the weight given to consumers, decontrol has a net fairness (or equity) cost of $1.9 billion.

This is probably a high estimate. Consumers bear a significant portion of the costs stemming from administrative burdens, support for OPEC pricing, impairment of U.S. ability to adjust to outside shocks, and overdependence on foreign oil. These costs, as we noted, are difficult to measure, but they are certainly large. If we take only the estimated $500 million current private and administrative compliance costs, and if we assume that three-fourths of these are passed directly to consumers, our estimated equity cost of decontrol declines from $1.9 billion to $1.5 billion. Similarly, if even one-half of the budget of about $200 million that is allocated to petroleum regulation could be freed by decontrol and applied to other programs, with benefits distributed roughly in proportion to income, the equity cost estimate would be reduced to $1.4 billion. Of the costs of current policies that are not readily measurable—impairment of macroeconomic adjustment, alteration of normal business practices in the petroleum industry, national security problems from increased dependence on foreign crude—it is fair to conclude that many fall on the general public, and perhaps disproportionately on those with relatively low incomes.

Comparing Gains and Losses under Decontrol

Forced to place dollar figures on the overall equity cost of decontrol—that is, its unfavorable consequences for the distribution of wealth—we come up with something like $1.4 billion as a generous but not unreasonable estimate. The conservative estimates of supply- and demand-side gains amount to approximately $2.5 billion. Less conservative estimates would raise this closer to $4.5 billion. Certainly, an efficiency gain in the range of $2.5 to $3.5 billion (scaling down our upper limit) is unlikely to be too high. But this estimate of benefits cannot be directly compared to the $1.4 billion equity cost without specifying who it is that would receive the benefits. If all of the efficiency gain goes to producers, for example, this gain would have an equity value of one-half of the efficiency improvement.

In fact, the net supply- and demand-side gains from decontrol would accrue to producers. If we maintain our assumptions about taxes on producers and the use of tax revenues, a portion of the producer gains would be channeled back to consumers and the $2.5 to $3.5 billion efficiency gain from decontrol would have a net equity value of $1.9 to $2.6 billion. This exceeds the $1.4 billion equity cost of decontrol. Of course, from the egalitarian point of view, a windfall profits tax (with revenues used to offset the distributional effects of decontrol) would increase overall equity still more than decontrol by itself; but the point here is that decontrol, even without such a tax, would have benefits that exceed its costs.

... even with standards of social justice that find the prospective transfer of income from consumers to producers highly inequitable, the efficiency gains from decontrol are dominant.

In short, our analysis indicates that, even with standards of social justice that find the prospective transfer of income from consumers to producers highly inequitable, the efficiency gains from decontrol are dominant. Consequently, with full cognizance of the distributional implications, we recommend deregulation of domestic petroleum prices. The nation quite simply pays too great a price for trying to maintain income patterns in their pre-OPEC status and trying to forestall the adjustment to a present and future of rising energy prices. ■

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SYNTHETIC FUELS

Should the government subsidize nonconventional energy supplies?

Paul L. Joskow and Robert S. Pindyck

THE CENTERPIECE of President Carter's energy policy is a program of massive subsidies to hasten the commercial development of synthetic fuels and other "nonconventional" energy supplies. While the ultimate size of the effort will be determined by the Congress, the administration has proposed spending over $100 billion in the next decade, and views this program as its major instrument for bridging the growing gap between our consumption and production of energy.

The particular sources of energy likely to be most heavily subsidized by this program include oil from shale rock and gas and liquid fuel from coal, but subsidies will also be allocated to solar energy, biomass, wind power, and other technologies. Producing energy from these sources does not require fundamental new scientific or technological advances. Shale oil was first produced in Britain in the 1850s, and gaseous and liquid hydrocarbons were produced from coal in Germany during World War II and are being produced today in South Africa. But energy from these sources is often called nonconventional because it is not at present being produced or consumed in significant quantities in the United States or, for that matter, almost anywhere else. The reason is quite simple—these sources of energy are extremely expensive. It is difficult to say just how much more expensive they are than conventional energy supplies, but estimates we have examined put them at twice the cost, on a thermal-equivalent basis.

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Of course, as conventional energy supplies become increasingly scarce and their prices rise, shale oil, gasified coal, solar energy, and a variety of other nonconventional sources may become commercially viable, and in fact may eventually displace conventional oil and natural gas as major fuels. When that day will dawn is difficult to predict. But if, as the Carter administration argues, it will be in the next decade, why is it that we do not already observe the private sector gearing up to produce these sources of energy in the absence of federal subsidies? More important, is it desirable to spend billions of tax dollars to subsidize these sources of energy sufficiently to make them economically attractive to producers and consumers? At a time when there is growing pressure to limit government spending in areas like health, education, and the environment, are these subsidies to specific energy supply technologies really in the public interest?

The Plan for Government Involvement

In the President's proposal for an Energy Security Corporation to support the commercial development of nonconventional energy, as in alternative plans, government subsidies take a variety of forms. First among these are direct subsidies to reduce the cost and increase the profitability of new energy technologies. The most common form of direct subsidy is the use of government revenues to finance part or even all of the construction of "demonstration plants" for nonconventional energy—a demonstration plant being a production facility at (or close to) commercial scale whose construc-

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tion provides a way of finding out the actual cost and operating characteristics of each technology. This information is useful more for evaluating the "commercial" possibilities of a specific technology than for obtaining basic or applied scientific knowledge.

Outside of the military and space programs (where commercial viability is not an issue), the government has traditionally focused its R&D expenditures on financing basic and applied scientific research, leaving industrial development and commercialization to the private sector where both the benefits and costs of expenditures can be most effectively balanced. But it is now argued that, without direct government subsidies to finance the construction of demonstration plants, private firms will face too much uncertainty to allow them to make the "correct" investments.

Of course any new technology involves uncertainty and requires an investment in learning—problems long recognized in our patent system. Private investors are normally willing to undertake such projects when the expected rewards from success are greater than the expected losses from failure. Yet we are now being told that, for nonconventional energy, the government should bear much of the cost and the risk because the private sector is unwilling to do so. We have not, however, been told why it should be necessary for the taxpayer to bear these costs if these technologies are in fact "good bets."

Tax credits are another form of proposed subsidy, though one that is somewhat less direct. If the production of a particular form of energy is at all profitable in the long run, tax credits will obviously increase the aftertax profitability. And even if a particular project is *never* profitable, tax credits may have the effect of reducing the overall tax burden to the companies, and thus making the new technology more attractive. The energy tax credits specified in the President's plan are substantially those contained in last year's unsuccessful energy tax bill. They include a $3 per barrel credit for oil from shale and tar sands, a 50¢ per mcf credit for geopressurized methane and for any gas from a nonconventional source, and residential credits for home insulation and expenditures on solar and wind energy.

Loan guarantees, likewise an indirect form of subsidy, are also part of the President's plan. Because shale oil and coal gasification and liquefaction projects have large capital requirements, debt-financing costs are a major component of total cost. By reducing the riskiness of loans, loan guarantees reduce financing costs. What this form of subsidy costs the public is difficult to measure, since that depends on the number and sizes of loans that default. An extensive program combined with a high default rate could be very costly.

We have gathered and evaluated cost data for several nonconventional energy sources and have found only limited prospects for profitability. To put it simply, at least for the next several years, conventional sources are likely to be cheaper than nonconventional sources (for specific data, see Saman Majd, "Financial Analysis of Non-Conventional Energy Technologies," MIT Energy Laboratory). It is therefore not surprising that the private sector has not been particularly interested in developing these sources without the government subsidies; indeed their development is probably not an efficient use of society's scarce resources. It does not make sense to invest large sums of money in projects that do not appear to be economical, unless it can be shown that there are good reasons why the decisions made by the private sector are inconsistent with the public interest.

[If those] who are in the best position to assess the commercial value of alternative energy supplies . . . are not interested in attempting commercial development, why should the taxpayer overrule their decisions. . . .

We must always remember to ask the question: if energy producers and consumers, who are in the best position to assess the commercial value of alternative energy supplies, are not interested in attempting commercial development, why should the taxpayer overrule their decisions and—what is worse—pay for doing so?

The Rationale for Subsidies

Two basic arguments are made in favor of government participation in the development of nonconventional energy supplies. The first says

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that the United States is becoming more and more dependent on imported energy from sources that are increasingly insecure and that we can reduce this dependence by accelerating the production of new domestic energy supplies. There is no question that U.S. dependence on imported energy is increasing as the gap between our energy consumption and our domestic energy production continues to grow. The issue, however, is whether there are more efficient means of bridging the consumption-production gap that would end up costing the American public less.

The second argument says that projects to produce these energy sources are of a special nature that makes it difficult or impossible for them to be undertaken by the private sector without government assistance. Moreover, the administration claims that the special nature of these technologies is such that government participation in their commercialization will be needed even when energy prices are higher. Proponents of this view usually point to the fact that commercialization of these technologies typically involves large capital expenditures and, in some cases, considerable risk, so that private firms would be unwilling or unable to raise the necessary capital and make the necessary investments. In effect, it is argued that there are significant market imperfections which make nonconventional technology *look* unprofitable to private firms, even though its social value is considerable, and that it is these imperfections which justify intervention.

Here we examine these two arguments in some detail to determine whether they do indeed justify the kinds of programs the Carter administration is now proposing. We also present what we think is the proper role of the government in the commercialization of nonconventional energy supplies—first in the context of an ideal, or "first-best," energy policy, and then in the context of a "second-best" energy policy operating under the kinds of political constraints that are likely to exist in the near future.

New Energy Technologies as a Substitute for Imports

Before we consider whether the subsidization of nonconventional energy supplies is a desirable way of reducing the gap between domestic energy consumption and production, we should be clear on just why that gap exists. For the last several years, U.S. energy policy has kept the domestic price of energy well below the world level. Maintaining an artificially low price for consumers—and domestic producers—has stimulated energy demand and, at the same time, reduced domestic production. Some 4 to 6 million barrels per day of our current 8 or 9 million barrels per day of oil imports can be traced directly to recent policies that have kept domestic energy prices far below world market levels. (See article by R. Hall and R. Pindyck in *The Public Interest*, Spring 1977.)

Two principal policies have been used to maintain a low domestic price of energy. One is the crude oil price controls entitlement program, which taxes the domestic production of oil (by holding its price below the refiner's price) and uses the proceeds of the tax to subsidize imports (thereby reducing the cost of high-priced imported oil to the refiner). This has had the effect of keeping the average price of crude oil to U.S. producers about 50 percent below the world price—and has had the interesting side effect of putting the U.S. government in the business of subsidizing oil imports from OPEC.

The second policy is the regulation of the wellhead price of natural gas, which has held natural gas prices far below the world market level for many years, producing domestic shortages even before the 1973 oil embargo. The Natural Gas Act of 1978 represents a major step in correcting this policy, although gas prices will not reach free market levels for several years.

Now the administration, in its synfuel proposals, is asking taxpayers to finance the difference between the high cost of producing nonconventional energy in the United States and the low price consumers will be asked to pay. But Americans will be much worse off with higher taxes than with higher energy prices. Individuals can choose to avoid paying higher energy prices by limiting their consumption, but they have no choice about the taxes they must pay. The proposed "commercialization" program will force consumers to pay a good portion of the high cost of energy indirectly, through their taxes. As a result, there will be little incentive to conserve, so consumption will rise while production falls. A growing tax

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burden will then be required to finance a growing amount of subsidized production.

Rather than subsidize nonconventional energy, it would be better to purchase oil and natural gas at home and from abroad at world market prices. Offering government subsidies of one kind or another to developers of new energy forms means requiring the nation to pay much more for energy than is necessary—which is exactly what government policy should avoid.

Offering government subsidies . . . to developers of new energy forms means requiring the nation to pay much more for energy than is necessary. . . .

A counter argument sometimes raised is that the development of more expensive nonconventional energy should be accelerated today so that lower-cost conventional energy can be saved for future generations. But this argument ignores the time value of money—which makes it cheaper for us to consume low-cost supplies now, in 1979/80, and higher-cost supplies then, in the future. As conventional oil and natural gas reserves are gradually depleted, the market prices of these resources will rise, so that eventually we will shift to higher-cost resources such as shale oil, gasified coal, and solar energy. To reverse this order of use by accelerating the commercialization of nonconventional supplies would only impose an unnecessary cost on the American public.

New Energy Sources and Market Imperfections

We have argued that if a new energy technology does not appear profitable to the private sector, its development may well not be an efficient use of society's scarce resources. But in some cases there may be significant market imperfections that make the technology *appear* unprofitable to private firms, even though its true social value is quite high. It is only in such a case that some type of government intervention might be desirable.

Those who advocate government intervention often point directly or indirectly to one or more alleged failures of the market. Here we examine those alleged failures that have attracted the most attention.

Energy Price Imperfections. As we have pointed out, government regulation has kept most energy prices below their true marginal social cost. But it is prevailing or expected market prices on which private firms base their decisions about the profitability of new energy technologies.

Government price regulation has therefore created an important disincentive to investments in new energy technologies. It may be that such investments are "justified" by a complete analysis of the costs and benefits to the U.S. economy, even though private firms do not find them attractive in the face of regulated energy prices that do not reflect the true social costs of additional consumption to the U.S. economy. Since energy prices are "too low," we cannot expect the private market to provide the proper signals on new sources of supply.

While price regulation clearly leads to an important market imperfection, it is an artificial one created by the government's own actions. To set things right the government can either eliminate the source of the problem by allowing energy prices to rise to replacement cost, or it can try to "balance" the disincentives created by regulation with additional incentives in the form of subsidies to new technologies. We will explore this matter later on.

Discount Rates. It is sometimes contended that private firms, when making investment and planning decisions, use discount rates that are "too high" and that therefore bias their decisions away from capital-intensive projects like the commercialization of nonconventional energy supplies. There are essentially four reasons cited to explain why private discount rates tend to be higher than the "social" discount rates that should be used to properly evaluate the benefit of a project to society.

First, it is argued that social discount rates are lower than private discount rates because private agents do not value the well-being of future generations sufficiently. Using a lower social discount rate would lead us to shift expenditures towards more investment (and less consumption) today and more consumption tomorrow. (Alternatively, some have argued

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that we should impute a lower social discount rate in cost-benefit calculations so as to account for external economies or public goods characteristics that are not properly accounted for by private decision-makers.*

Second, it is argued that market interest rates ordinarily include some premium for the risk (or uncertainty) associated with the investment. This risk is reflected in (real and nominal) differences in the interest rates of risky and safe assets. Proponents of subsidies argue that such risk premiums would be unnecessary with government investment projects, since the government is so large and has so many projects over which it can diversify risk that its investments could be treated as being riskless. Government investments would therefore be evaluated at lower interest rates than those private firms use, reducing their apparent costs and making the investments more profitable from a "social" point of view.

Third, it is argued that corporate taxes distort discount rates, since the rate of return on private projects must include a provision for the payment of income and other taxes. According to this argument, because the government does not have to pay taxes to itself, the social rate of discount would be lower than the private discount rate, making projects "socially profitable" even though they are unprofitable in the private market.

Finally, it is argued that the *social* returns from domestic energy projection are higher than the private returns. A reason given for this is that an increase in domestic production will lead to a reduction in imports, which in turn will lead to a reduction in the OPEC price.

For alternative energy sources, all four arguments are largely specious. Most of the historical discussion of social discounting has been conducted in the context of very large capital-intensive projects (such as dams), which have very long lifetimes as well as public goods characteristics and external economies, and which will be owned and operated by the government. But new energy technologies do not fit this bill.

There is also little evidence that private firms "overdiscount" the future, though this is a question not really subject to objective analysis. In any case, there is no reason to believe that such an effect would appear only in energy supply and demand decisions.

While it is true that government bonds will carry a lower interest rate than other bonds because bondholders always expect the government to pay up, this is risk reduction from the viewpoint of investors rather than from the viewpoint of society. If new energy technologies are inherently risky, there is little reason to believe that the government can make them any less so. Government only shifts risk from investors to taxpayers: it does not eliminate it.

It is true that the government might be in a better position to diversify risks than the private capital market when such extremely large amounts of capital are involved that the risks of default cannot be adequately absorbed by a single firm or a consortium of firms. But such situations are rare. The investments contemplated for most new energy technologies are not significantly larger than the amounts the energy industry has been able to raise in the past. Private firms have had little or no trouble in raising capital for projects like the Alaskan pipeline, liquefied-natural-gas tankers, oil refineries, and large chemical plants—projects whose capital requirements were of roughly the same magnitude as a shale-oil or coal-gasification plant. If there is a problem here it is not in the size of plant investments required.

The argument that taxes distort discount rates is likewise specious. The capital that might be used by the government to finance a project has an opportunity cost—that is, it is withdrawn from the private sector, thereby losing returns from private investments that would otherwise have been made and losing tax revenues that such investments might have generated. In short, the cost of obtaining funds for public investment projects is equal to the gross rate of return, including taxes, forgone by diverting this capital from the private sector to the public sector.

Finally, it is unlikely that a reduction of 2 or 3 million barrels per day of imports (in 1990) will significantly affect the OPEC price, since the United States simply does not have enough effective monopsony power as a buyer of OPEC oil. But even if it did, subsidizing particular synthetic fuels is surely not the most cost-effective way of reducing imports.

*By "public goods characteristics" we refer in particular to the fact that once a "public good" exists (a highway, a dam, or a navy), it costs little or nothing for each additional user to gain its benefits—which, of course, makes cost allocation difficult.

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It is thus hard to be impressed by arguments that private decision-makers use a discount rate that is "too high." Let us therefore turn to the other arguments about market imperfections.

Capturing the Benefits of Technological Information. Considerable technological information might of course be forthcoming from greater R&D efforts. But—it is argued—because this information is difficult to keep private, the benefits will not all accrue to private investors, and thus private firms will tend to underinvest in R&D. Alternatively, greater patent protection might solve this problem but would be undesirable because of the distortion caused by the resulting monopoly power.

While this argument is generally true for R&D activities that produce basic scientific and technical knowledge, it is not applicable to the commercialization of new energy technologies. Commercialization is not basic research. Most new energy technologies that are candidates for huge subsidies are well understood. While there may be some uncertainty about their ultimate cost, the uncertainty is no greater than what is involved in many other ventures commonly undertaken by private firms. Thus, while a good case can be made for government funding of basic energy research activities, the argument does not apply to government funding for the industrial development and commercialization of alternative energy technologies.

Regulatory Uncertainty. The technological and economic risks of new energy technologies are likely to be overshadowed by uncertainties about environmental regulations. Environmental (and other public policy) controversies surrounding the Clinch River Breeder Reactor and the Barnwell Reprocessing Plant are examples of the kinds of problems potential investors fear.

Uncertainties over the ability to meet current and future environmental standards are present in many industrial investments, but are probably greater for such energy technologies as shale oil and coal gasification. These technologies raise new and different environmental questions, and to the extent that environmental standards may not be promulgated until the plants are operational, there may indeed be significantly greater regulatory uncertainty.

The environmental problems fall into three main areas: air quality, land, and water. Plant emissions and fugitive dust can cause air quality problems. Second, both the plants and mines needed for these coal technologies and the disposal of the spent shale may seriously scar the landscape. Indeed the use of the land for these plants may permanently destroy vegetation and wildlife and, as with Appalachian coal-based synfuels, render agricultural and forest lands unsuitable for their original use, even with reclamation. Reclamation and revegetation would be even more difficult in areas of low precipitation. Finally, the development of these technologies raises concern over the adequacy of water supplies and the pollution of existing sources, since synthetic fuels production requires large quantities of water. In some regions this would mean a shortage of water for other uses (for example, agriculture). Discharge of pollutants into surface streams and leaching into underground sources are dealt with at the planning stage by designing the plants for "zero-discharge," involving recycling of spent water for use at the plant site. But whether the discharge will be quite "zero" at full-scale operation remains to be seen.

It has been argued that understanding and solving the environmental problems presented by new energy technologies may require the technology to operate for some period of time. While this would provide the information needed to draw up regulations, the technology may not be developed without clearly defined regulations because of the associated uncertainties. To the extent that this dilemma exists, the construction and operation of first-of-a-kind facilities may have "public goods" characteristics that would justify some form of government intervention. On the other hand, regulatory reform, leading to the removal of unnecessary, even counterproductive, regulations and to a clarification of the kinds of environmental standards likely to be enforced in the future, seems a better way of dealing with this kind of market imperfection.

The Proper Role for Government

If the President's proposals are adopted, subsidized nonconventional energy supplies will soon be relied upon to help close the growing gap between the consumption and production

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of energy in the United States. This would indeed be unfortunate. Most of the gap comes from price controls on crude oil, natural gas, and electricity, and it would be much more effective and much less costly to eliminate the regulation that produces the gap than to subsidize expensive energy substitutes for low-priced but nonavailable energy. Eliminating price controls would enable us to begin using nonconventional energy supplies as they become economically viable.

Of the various forms of market imperfections . . . put forth as reasons for government intervention, the . . . most serious is uncertainty over future regulation.

Of the various forms of market imperfections that are put forth as reasons for government intervention, the most real and most serious is uncertainty over future regulation. We have noted the existing uncertainty about future environmental constraints and regulations, but of even greater concern to the potential producer of new energy technology is uncertainty over future government *price* regulation.

The commercialization of shale oil, for example, is a risky venture. Indeed, if private firms do undertake it, they will do so only because they see a profit potential large enough to warrant the considerable risk. The fear of private firms, however, is that while they will be permitted to lose almost any amount of money, they will not be permitted to make almost any amount of money. Firms considering shale oil projects rightly worry that, if the world price of conventional oil rises considerably over the next decade so that a shale oil facility turns out to be an economic success, the government will then regulate the price of the shale oil, thereby reducing the profits that can be earned.

Private firms usually have no problem with downside risk as long as there is a commensurate potential for profit on the upside. The problem with nonconventional energy supplies is that firms are unwilling to take downside risk when they perceive a probable government ceiling on upside potential. It is therefore not surprising that these firms are asking for various forms of government subsidies to limit their downside risk. Once again, government subsidies are a costly and unnecessary alternative to dealing with the problem directly. The removal of price controls—and the guarantee that controls will not be imposed on the prices of nonconventional energy supplies produced by the private sector in the future—would eliminate the one form of market imperfection that is indeed significant and serious.

Decontrol of the current and future prices of energy supplies is the most important part of a "first-best" energy policy. This, together with a revision of those environmental regulations that are unnecessary and unreasonable and a clarification of environmental standards and regulations that would apply in the future, would permit private firms to develop new energy technologies at a socially optimal rate. There would then be little or no need for the government to subsidize the commercialization of these technologies. While we would hope to see continued government support for basic energy research, subsidies for the production of nonconventional energy supplies are no more warranted than subsidies for the production of sugar, tobacco, or peanuts.

. . . subsidies for the production of nonconventional energy supplies are no more warranted than subsidies for . . . peanuts.

It has been argued that the deregulation of domestic energy prices is politically impossible, at least over the next several years. Would this make government subsidies for new energy technologies desirable? That is, if we cannot have the "first-best," what role should the government play in the commercialization of these technologies as part of a "second-best" policy?

In this case, the government should use its limited resources to reduce the cost (or the risk) of producing nonconventional energy supplies, but should avoid determining the specific technologies to be developed. An especially attractive way to do this would be for the government to provide price guarantees or purchase agreements for broad categories of nonconventional energy supplies, rather than subsidizing specific demonstration plants or tech-

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MORE REGULATION OR BETTER THERAPIES?

William Wardell

THERAPEUTIC DRUGS are quite literally a life and death matter: declines in the development of these drugs and unreasonable barriers to their use mean that men and women will be sick who might be well and will die who might live. Doctors and (one hopes) patients know this, and so do the Congress and the Food and Drug Administration (FDA). But no one is quite sure what can be done to remedy the problems we face in this area today—ever-growing research time and costs, delays in new drug introduction, declines in the innovation that could produce better drugs.

This is not a new concern, nor one that has escaped the attention of policy-makers. Congress has been discussing comprehensive reform measures for several years, while over at the FDA a task force began to rewrite that agency's regulations on drug development and approval last February.[1] Then in June, the General Accounting Office issued a preliminary report on its two-year study of the FDA's new-drug approval process. As with most of the eleven past public inquiries into this subject, the GAO study points to bureaucratic holdups, communication problems, and, as a consequence, excessive delays. It notes, for example, that the average time from submission of a new drug application to approval of the drug for marketing is now thirty-four months, whereas the statutory requirement is six months.

From the excessive delays in the approval process come delayed new drug introductions —some of them so delayed that drugs that have been used safely abroad for years are not yet available here. This is the "drug lag." The GAO identifies several causes of the problem, some amenable to legislative or regulatory action but most requiring better operating practices within the FDA and also the pharmaceutical industry. It is my judgment that the drug lag and the unhealthy state of pharmaceutical innovation in the United States (a subject the GAO's report does not cover) stem largely from an underlying malaise in new drug regulation.

The Drug Lag

This is, as I say, not a new problem. It became obvious back in the late 1960s—in the wake of the 1962 amendments to the Food, Drug, and Cosmetics Act. And, in the intervening years, it has become even more acute.

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[1]These are the IND and NDA regulations, respectively. IND refers to the Investigational New Drug exemption. An IND application must be filed with the FDA before human studies on a new drug can begin. When sufficient data on the drug's safety and efficacy are available from clinical studies, an NDA (New Drug Application) is submitted to the agency. When this is approved—signifying that the FDA deems the safety and efficacy data to be adequate for specific therapeutic indications—the drug may be marketed in this country for those uses.

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The drug lag is most dramatically revealed in comparisons of this country and the drug-developing countries of continental Europe. But it is most thoroughly documented in studies comparing the United States with Britain—a country with comparable standards of medical practice and the only other English-speaking country that develops drugs in significant numbers. Our research team at the University of Rochester recently completed a new update study of this problem. In nine therapeutic areas examined in detail for the period from January 1962 through March 1979, three to four times as many new drugs became exclusively available in Britain as here. Of that minority of new drugs introduced into both countries, about twice as many were introduced earlier in Britain—often by many years.

But drug availability is not the only way regulation affects therapy. Another important factor is the range of therapeutic indications—that is, the disease conditions—for which a drug is approved by the FDA. Since the United States imposes the most specific (restrictive) labeling approvals of all major drug-developing countries, simple numerical summaries that reveal the smaller number and later availability of drugs here substantially *underestimate* the therapeutic constraints on U.S. doctors and patients.

Many of the drugs that have been delayed in reaching the U.S. market are therapeutically important. For example, the United States was the fifteenth country in which the anti-inflammatory drug indomethacin was marketed, also the fifteenth for the diuretic ethacrynic acid, the thirty-ninth for cephalexin (the first oral cephalosporin), and the fortieth for the anti-tubercular antibiotic capreomycin. Yet all of these drugs were developed by U.S. firms. When the advance originated with a foreign-owned firm or institution, the United States has usually been even further down the list. It was the thirty-second country to approve the important anticancer drug adriamycin, the forty-first to approve the antimania drug lithium carbonate, the fifty-first to approve the anti-tubercular drug rifampin, the sixty-fifth to approve the anti-asthma drug cromolyn sodium, and the one-hundred-and-sixth to approve the antibacterial drug co-trimoxazole.

We can gain added perspective on the drug lag by looking at specific therapeutic areas.

- *Cardiovascular drugs.* Although cardiovascular disease—including heart attack and stroke—has been the main cause of death in the United States for many years, this is an area in which the differences in the therapies available in the United States and Britain have been particularly large. To all intents and purposes, the FDA's doors were essentially closed to cardiovascular drugs for an entire decade.

Thus, in the years 1963–73 when new antihypertensive drugs were continuing to appear in Britain, none was approved for use here. Since 1973, U.S. mortality from stroke has declined in part because of the National High Blood Pressure Education Program. But new management at FDA's Cardio-Renal Division has also helped by overcoming that division's logjam in antihypertensive drug approvals. As a result, the availability of antihypertensive drugs in this country is now more in line with world trends, although certain lags persist.

Cardiac arrhythmias are a common cause of coronary death. Yet only two antiarrhythmic drugs were approved in the United States from 1962 to 1975, both after substantial lags, while another important antiarrhythmic has been in regulatory limbo since 1968, at least in part because of the powerful inhibitory influence of a single FDA reviewing officer.

In the area of heart attack prevention, another FDA reviewing officer blocked even research on the problem. In 1969, this employee prevented E.R. Squibb and Sons, Inc., from conducting a controlled study to determine whether aspirin in normal doses would prevent heart attack and death in patients who had already had a heart attack (and were hence at high risk of having another). The FDA made repeated demands for additional data and animal studies, requested the submission of all the world's literature on aspirin, and even wanted to close down Squibb's entire clinical research program on *all* drugs if the firm went ahead with its aspirin project. Squibb finally dropped the project. In 1974—five years later—the National Institute of Health initiated a $16 million investigation (paid by tax money) of precisely the same effects of aspirin. If, when the NIH study is completed a year from now, it confirms what has long been suspected about the beneficial impact of aspirin on heart attacks and coronary death, then the health costs of having had that knowledge frivolously delayed for sev-

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eral years—costs of illness, lost days of work, burdens on families, and death—will have been extremely high. The popular allegation that aspirin "couldn't be approved for marketing if it came along as a new drug" is no joke: in 1969 aspirin could not even get to the starting line.

The popular allegation that aspirin "couldn't be approved for marketing if it came along as a new drug" is no joke: in 1969 aspirin could not even get to the starting line.

The fact that even a well-known drug like aspirin could be subjected to ridiculous research barriers of this kind suggests the height of the hurdles confronting really new and important investigational drugs at the FDA during that bleak period—and also illustrates the extreme vulnerability of the industrial firm that argues with the FDA. Moreover, the fact that the situation improved after the agency made management changes illustrates the powerful influence that individual personalities and management practices can have on drug development in the United States. Examples like this (and there are many others) should be borne in mind in discussions of overregulation of pharmaceutical innovation.

- *Respiratory drugs.* Years of delay in the availability of at least four respiratory drugs (metaproterenol, terbutaline, cromolyn sodium, and beclomethasone inhaler) represented severe disadvantages to many asthma sufferers in this country, who had to settle for older therapies that were less effective and more dangerous than the newer drugs available abroad. By now the most glaring therapeutic gaps in this area have been eliminated.
- *Central nervous system drugs.* Many new antidepressants are available in Britain but not in the United States. While it is not clear that these British drugs offer any great advantages in efficacy, some of them are much safer than their U.S. equivalents. This is a particularly important characteristic for drugs designed to combat a condition in which attempts at suicide are common. All antidepressants on the U.S. market are particularly lethal when taken in sufficient overdose.

There are also significant U.S.-British differences in the drugs available for epilepsy. Of the eleven anti-epileptics approved in Britain or the United States from 1960 through March 1979, none was introduced here only, and just one became available earlier here. The six-year lag in the availability of valproate, in particular, and the continued absence of nitrazepam substantially reduced the treatment options for epileptic patients in this country.

Finally, patients who suffer from migraine could benefit from drugs either available exclusively or approved earlier in Great Britain for that indication—for example, clonidine, propranolol, and pizotifen.

- *Gastrointestinal drugs.* The absence of carbenoxolone (for peptic ulcers) and chenodeoxycholic acid (which dissolves gallstones) and the delays in the availability of metoclopramide, lactulose, pentagastrin, and (despite its claimed "fast-track" treatment) cimetidine have had important effects on the health of U.S. patients who suffer from gastrointestinal diseases. The chenodeoxycholic acid case is particularly interesting. From studies performed abroad, we already know that this drug is effective. Yet it appears that even before the required U.S. studies are completed, the drug will have been superseded abroad by a related drug (ursodeoxycholic acid) that is more effective and less toxic.

Counterarguments

The first line of defense of successive FDA commissioners has been to deny—at least when in office—that a drug lag existed, while avowing, nevertheless, that they would abolish it. (The defendant claims his dog could not have bitten the plaintiff because he did not own a dog and he kept it chained up.)

The first line of defense of successive FDA commissioners has been to deny—at least when in office—that a drug lag existed, while avowing, nevertheless, that they would abolish it.

The FDA's second line of defense has been to claim that the lag is beneficial or, at the least,

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unimportant. The claim that the lag is beneficial is, in essence, an argument that the United States has avoided substantial new-drug toxicity by avoiding new drugs. Ironically, the drug chosen to illustrate this (the beta-blocker practolol) has, despite its known toxicity, an extremely high benefit/risk ratio when used to prevent heart attacks and coronary death. If practolol were available and used optimally in heart attack patients here, I estimate that it would save at least 10,000 lives a year, with a degree of toxicity that would be small, controllable, and highly acceptable to those patients at risk, given the drug's life-saving benefit.

The claim that the drug lag, while not beneficial, is unimportant necessarily assumes that there are adequate substitutes here for the drugs that are unavailable. But this discounts the fact that substitutes are usually not exact substitutes. Patients can benefit from the expanded range of efficacy or toxicity provided by having a wider variety of drugs—even when, on "average," the drugs may look similar in clinical trials. Two drugs that each benefit 50 percent of the population might together cover 100 percent of the population if their spectrum of efficacy does not overlap. Furthermore, certain drugs that may not benefit the "average" patient often have great advantages for certain individuals. Having more drugs available enables physicians to tailor therapy to individual patients, thereby providing maximal efficacy, safety, comfort, and convenience.

Declining Drug Innovation

The drug lag is a visible symptom of even more fundamental problems in the process of U.S. pharmaceutical innovation. A more sensitive quantitative measure of innovation is the flow of new chemical entities (NCEs, meaning new molecular structures) from the laboratory to the testing-in-humans stage—one of the earliest points at which the drug development process comes under regulatory control.

Very recently my research group at the University of Rochester obtained data from the whole U.S. pharmaceutical industry on all NCEs first tested in humans from 1963 through 1976. Among our major findings are these:

(1) Only a small portion of the U.S. industry creates and does research on truly new molecules: as few as seven of the thirty-six companies making up the research-based part of the industry account for half of all new NCEs tested in humans.

(2) Increasingly, the first testing of U.S.-originated NCEs in humans is done abroad: up through 1969, the fraction was 10 percent, but the most recent data indicate this could now be as high as 45 percent. The trend is even steeper for the large multinational companies because they already have foreign research capabilities.

(3) The number of NCEs studied in humans each year by the entire U.S. industry has generally declined since 1964, falling particularly sharply (possibly by as much as 40 percent) between 1974 and 1976.

(4) The average time required from filing an investigational new drug application to gaining approval for marketing (for the one out of ten that is eventually approved) rose from six years in 1974 to nearly nine years in 1976. Of this time, six years are required for the IND (clinical investigation) phase, and two-and-a-half years for the NDA (application for marketing) phase.

(5) Preliminary data on all NCE IND filings by U.S.-owned firms indicate that the proportion that is self-originated (rather than, say, licensed from foreign firms) fell sharply, from about 80 percent (or more) over the period 1967–75 to 63 percent in 1976.

There is thus a substantial decline in U.S.-originated drug candidates now in the pipeline and potentially available for marketing nine years hence, a continuing rise in the duration and thus the costs of development, an increasing movement of U.S. compounds abroad for early clinical testing, and an increasing reliance by U.S. firms on outside sources of innovation.

Other data support the picture emerging from these observations. The high cost for a U.S. firm to bring an NCE to the U.S. market, estimated at $54 million by Ronald Hansen, represents a substantial barrier, especially to smaller firms. An additional disincentive is the dwindling patent life that remains as development time increases. Since the seventeen-year patent clock runs during the whole development and approval phase, the average effective patent life for NCEs that received NDA approval fell from 13.8 years for those approved in 1966 to 8.9 years for those approved in 1977. This decline was fairly closely accounted for by the rise in development and approval time.

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We can thus expect the incipient downward trends in U.S. innovation to continue unless something unusual happens in the environment for innovation. Despite the tinge of euphoria engendered by an increase in NCE NDA approvals in the past year or two, that environment has not improved. This is the most important—and most depressing—finding from the most recent data. It means that, beginning about 1984, there will be a substantial decline in U.S.-originated NCEs reaching the U.S. market.

Similar influences affecting at least two related areas could foreshadow the fate of drug research. In vaccine research and production, because of decreasing financial returns and increasing risks, the role of the private sector has declined markedly while that of government has increased—a situation that concerned the government-sponsored task force that examined the problem recently. Second, in the area of medical devices, which was subjected to tighter regulation under the Medical Device Amendments of 1976, the fate of small, highly innovative firms is of particular concern.

Why the Decline?

Clearly, no single factor is solely responsible for the decline in innovation and the attendant drug lag. Nevertheless, regulation stands out as a dominant cause, partly because its influence on innovation is so direct and powerful. For example, the four sets of regulations recently issued or proposed under the FDA's Bioresearch Monitoring Program (which seeks to improve the quality and reliability of clinical and preclinical data) will raise new barriers to research by an amount and at a cost that cannot possibly be justified (even leaving aside the FDA's direct costs—$16.4 million for the program in the first year, with an additional 600 inspectors to enforce it).

Even beyond the high cost of developing new drugs, firms are concerned about the return on their investment once the drugs are developed. Except for the occasional and elusive big winner, there is an increasing likelihood that drug firms may not be able to earn a profit adequate to justify new investments in research, in part because government agencies are increasing the number and scope of costly drug utilization controls. These controls include HEW's Maximum Allowable Cost Program (which restricts the amounts that government can pay for multiple-source medicines) and third-party fiscal reimbursement regulations (which determine the diseases for which drugs can be prescribed). Moreover—and this compounds the problem—increasing fractions of the funds previously devoted to innovative research are now being diverted into defensive or wheel-spinning work to satisfy rising regulatory requirements.

There is, however, one factor that does *not* contribute to the decline in innovation, and that is our scientific knowledge base in pharmacology. The exciting increase in our scientific understanding is one of the few bright parts of the picture. Nevertheless, in a curiously bold move, the FDA has touted a transparently specious "knowledge exhaustion" hypothesis to explain the decline in innovation. At first, the FDA asserted that pharmaceutical innovation was slowing down worldwide because the supply of basic biomedical knowledge had been somehow "outrun." More recently it has claimed that the acquisition of exploitable biomedical knowledge is cyclical and that the world has been at the bottom of the cycle since the early 1960s. Both ideas are so preposterous —so reminiscent of Lysenkoism—that they should embarrass their sponsors. Their attraction to FDA personnel appears to lie in their ability to deflect attention from the inhibiting influence of regulation rather than in intrinsic truth.

Efficacy: Subtleties and Idiosyncrasies

While the overt effects of drug regulation are obvious, it is not generally recognized that the problem lies more in a subtle conflict over scientific nuances than in gross statutory and regulatory dicta. The proof-of-efficacy requirement in the 1962 amendments to the drug law is in itself reasonable, and so are the 1970 regulations by which the FDA officially interprets the law. The problems stem in the first place from the FDA's reading of its regulations and from the judgment calls of its reviewing officers and advisers, who make necessarily subjective decisions on whether specific data meet what they believe to be the FDA's constructions (written or unwritten) of its own regulations. Yet, in a sense, what the FDA and its officers do is itself

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part of a larger problem—the constant pressure on the FDA to be excessively strict.

When Is a Study Not a Study? The definition of the 1962 requirement for "substantial evidence" was worded in the plural: there must be "well-controlled investigations." The FDA has consistently interpreted this to mean at least two significantly positive well-controlled clinical studies of efficacy before a drug can be approved. But this turns out to cause problems.

Results from one recent multi-center study showed that the drug arabinoside-A reduced the mortality from one kind of encephalitis (herpes simplex) from 70 percent to less than 30 percent. The single study was the joint product of fourteen separate clinics following a common protocol. But it was only one study—or was it? In other words, did the FDA still need an *additional* placebo-controlled study (in which a precisely calculable number of Americans would have to be sacrificed to prove the efficacy of a drug everyone already knew was efficacious), or could the agency somehow avoid the constraints of its two-study interpretation?

By a clever metaphysical end run, the FDA succeeded in doing just that—first, by saying that a multi-center trial would qualify if *three* separate investigators within the study demonstrated significant results within their own sets of patients and, then, by ignoring the three-investigator requirement when it proved obviously inapplicable to a study involving only fifty patients in all. As far as one can tell, this represented a sensible course for the FDA. But from "two studies" to "three investigators" to neither of these seems a little tortuous. It would have been better to have avoided the original rigidity of the "two-study" interpretation.

It must be conceded, however, that there is a climate of opinion giving the FDA good reason to try to stick to the most conservative interpretation of any law or regulation. In 1974, for example, the agency approved the beta-blocker drug propranolol for use in angina pectoris—a gesture at least six years overdue. Thirteen published studies were correctly deemed by the FDA to be "well-controlled" and thus to satisfy the law's "substantial evidence" requirement. Later, however, the agency was unfairly harassed at oversight hearings of the House Intergovernmental Relations and Human Resources Subcommittee when a stunningly ignorant and biased consultant alleged (erroneously) that every one of the thirteen studies had unacceptable defects. The committee then asserted that the FDA had broken the law in approving propranolol for angina without the requisite two well-controlled studies. This bizarre case shows why the FDA tends to seek protection in the letter of the law—or of its own regulations.

Is Foreign Evidence "Evidence"? Other times, as noted, the FDA shows no inclination to avoid unnecessary arbitrariness. Thus, one cause of delay in drug availability (and of ethical concern as well) has been the FDA's longstanding demand that, in general, two controlled trials be conducted *in the United States*, regardless of data already available from abroad. Although the agency published new regulations in April 1975 that would allow it to accept foreign clinical results under certain conditions, it is not clear that it is now following these regulations. Consider this excerpt from a proposal by FDA to its Cardiovascular Advisory Committee in May 1977 on the regulatory handling of beta-blocker drugs:

> How much U.S. data will be required *when adequate well-controlled clinical studies have been conducted abroad?*
>
> *If foreign studies are adequate* to evaluate safety and effectiveness for both short and long-term use, then *two adequate and well-controlled short-term studies will be required in the U.S. to corroborate* the findings. . . . If only short-term studies are available, then two long-term U.S. studies would be necessary [emphasis added].

The requirement for two U.S. studies when foreign studies *are* adequate is at best questionable. It also raises serious ethical issues of the same type as were raised by the example of the encephalitis drug discussed earlier: if a drug has already been shown to be effective (in this case, abroad), how many U.S. subjects must be tested to re-prove efficacy? If a drug reduces mortality (as certain beta-blockers do), how many Americans have to be sacrificed here? In cases where foreign data are not suspect, such chauvinism is indefensible.

When Is an Efficacious Drug Not Efficacious? Here, too, there has been no attempt at an end run. According to one FDA official, a drug considered by the agency to have substantial poten-

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tial uses *other than* those for which its safety and efficacy have been established should not be approved for any use until these other potential uses have been adequately studied. An example of this policy is seen in the FDA's ruling that drugs belonging to a class known as nonsteroidal anti-inflammatory analgesics could not be approved as analgesics for any indication—no matter how potent they were as analgesics—unless at least a short-term study was performed to ascertain their anti-inflammatory potential for treating rheumatoid arthritis. The mind boggles at what this philosophy would do to the age-long search for the elusive, strong, but nonaddicting painkiller that the world needs so much. Fortunately, this particular construction was repealed in February 1979, but the philosophy underlying it pervades other therapeutic areas.

In this regard, the regulatory handling of beta-blockers is similar but even more complicated. It was suggested in the FDA's 1977 beta-blocker status report (and the view has apparently been adopted) that at least initial studies on *three* indications (angina, hypertension, and arrhythmia) should be carried out before a beta-blocker could be approved—even if the evidence were adequate—for any *one* of these uses. While reasons can be adduced to support this position, it is difficult to reconcile it with the straightforward intent of Congress that drugs should be shown to be effective for their labeled use.

This interpretation—like much of the FDA's body of operating practices—is neither in the law, nor—as far as I can determine—in the written regulations. It is an ad hoc ruling that nevertheless has the effect of law. It is these rulings and interpretations, some of them apparently unwritten, that one questions when asking whether the FDA's practices reflect the intent of Congress, or indeed the intent of the FDA's own written regulations.

How Should the System Be Improved?

Dr. Jere Goyan, who succeeds Donald Kennedy as FDA commissioner in October, will be trying to improve regulatory performance. What steps might he take?

The Research Process. There is general agreement on the need to unburden the early stages of clinical drug investigation (Phases I and II). Since the safety record for these stages is excellent, the FDA could be permitted to delegate responsibility for monitoring and reporting to the clinical investigators and the sponsors, with supervision by local ethical review committees and with the final results reported to the FDA.

But even while Congress has been considering such a change, a considerable burden of additional regulation has been proposed or actually put in place. Among those being proposed are the sponsor/monitor, clinical investigator, and Institutional Review Board regulations emanating from under the FDA's Bioresearch Monitoring Program; among those already in place are the Good Laboratory Practice regulations. Such ponderous rules will dampen and dissipate research effort—especially clinical research—while increasing the costs enormously. It is doubtful whether they will improve data quality since, by the FDA's own assessment, the room for improvement is not great.

In addition, the FDA is currently rewriting its entire set of IND/NDA regulations, a complex and important task that offers opportunities for facilitating or inhibiting new drug development. The wrong choices here could bog down therapeutic progress for the rest of this century. To optimize the welfare of present and future patients, it is essential that needless duplication of clinical research should be minimized. Requirements for the repetition of experiments where the outcome is already known (from either foreign or domestic studies) are ethically unsound for the patient, the investigator, and the sponsor, and could even put the regulatory agency itself at legal risk.

The Review and Decision-Making Process. One obvious improvement—attractive and eminently feasible because it would only involve changing the sequence of the review process—would be to start the NDA review as soon as the data generated under the IND studies started to come in. It is nearly incomprehensible that the NDA review should take almost three years (GAO's findings for 1978) following upon the six years already taken to generate the data. If this review were begun at the time the first results came in and were kept current, only the last study results and the sponsor's and FDA's summaries would have to be reviewed from

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scratch at the time of NDA submission. This could easily be done in six weeks, thus cutting at least two years from the total NDA review time currently required without altering any of the current data requirements. FDA has been talking of such a "developing NDA" approach for at least two years, and should be encouraged to proceed with it. If resource constraints are hindering this, it would make sense to address that need at once.

Other problems in the review process could also be taken care of without any fundamental changes. It would surely help if the FDA were fully staffed with all the experts it needs to review new drugs and if arrangements for enabling FDA staff to have the benefit of expert outside advice were improved. The GAO report commented on the uneven distribution of work among FDA personnel, and it is my own impression that individual workloads are so high in some areas that the review of new drugs may be substantially delayed. I believe society would have gained more from 100 additional highly skilled reviewing officers and $5 million than from the 600 new biomonitoring policemen recently authorized at a first-year cost of $16 million. And if in-house experts are overburdened, the FDA should use more outside experts (for example, on contract) and more advisory committees. To this end, the extremely strict conflict-of-interest interpretations that now make it virtually impossible for some of the nation's best experts to serve on advisory committees should be relaxed at once. Attention should also be given to putting patients or members of the relevant nonprofit disease-oriented organizations on these committees. It is they who have a particular stake in the prudent consideration of the issues surrounding therapies in their specific areas—especially the high-risk therapies that regulators shy away from but that some patients so desperately need.

But a lot more could be done if we critically examined the current development and approval process. As things now stand, the embattled regulator has to make an all-or-nothing decision on a drug, and is therefore naturally cautious, inclined to ask for ever more data and to defer a decision until all conceivable doubts are resolved. Asking for more data is an easy way out. What is needed is to make the decision less apocalyptic and hence easier to make—perhaps by having it shared with advisory committees and by using enhanced postmarketing surveillance to catch any problems that might arise after marketing has begun.

Improved postmarketing surveillance makes good sense in any case, but it also offers a way out of the ever-increasing spiral of premarketing demands. While taking some of the pressure off the regulators, it could also, if used appropriately, facilitate drug development and increase the patient's protection at the same time. But while everyone agrees that more postmarketing surveillance is desirable, the question is whether it would actually be used to end (or even slow down) the spiraling demand for premarketing studies. The idea of a tradeoff has become obscured. Back in 1970, the anti-parkinsonian drug L-Dopa was approved for marketing at the end of Phase II trials, in return for a commitment by the sponsors to what ultimately proved to be a five-year program of intensive postmarketing surveillance of over 1,000 patients using the drug. (It is widely acknowledged that this early-release procedure was urged upon the FDA by congressmen suffering from Parkinson's disease who were anxious to obtain the drug's benefits themselves.) The tradeoff worked well. But recently, in the case of the drug azaribine, the FDA was accused of breaking the law when it permitted the sponsor to market the drug while conducting specified postmarketing surveillance in place of continued Phase III studies, which the sponsor claimed it could not afford. (The drug was withdrawn from the market a year later because of its toxicity, but the wisdom of that withdrawal can be sharply questioned.)

... the present system for discovering, developing, and regulating new drugs is, by its burgeoning weight, inexorably crushing innovation to death.

The danger is that, given society's current attitudes, enhanced postmarketing requirements will simply be added on to existing premarketing requirements, raising even higher barriers to new drug development and leaving the patient no better off than before. But something must be done. Despite sincere attempts

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at improvement by both the FDA and the industry, the present system for discovering, developing, and regulating new drugs is, by its burgeoning weight, inexorably crushing innovation to death.

I propose that, in all but very unusual circumstances, an adequate postmarketing surveillance protocol be substituted for the whole of the current Phase III portion of clinical investigation. That is, a drug should normally receive NDA approval if satisfactory efficacy and safety results have been obtained in the Phase II studies, subject to a commitment by the sponsor to perform postmarketing studies in accordance with a study design fully adequate for that particular drug. It is possible that "fully adequate" postmarketing surveillance could involve limitations on a drug's distribution or use in its earliest period of marketing—a highly controversial idea contained in most of the recent drug reform bills (for example, S. 1075) as well as in the GAO's report. I believe, however, that this additional step should only be required with occasional drugs and for special reasons. The crucial advance would be the development of truly effective postmarketing surveillance and the use of this form of "insurance" instead of Phase III testing.

This is not so radical a suggestion as it seems. Current Phase III trials, although the most costly and time-consuming part of the clinical development process, add very little to what has already been learned about a drug's efficacy and toxicity by the end of Phase II—and not nearly as much as is routinely learned through a few months' worth of high-grade postmarketing surveillance. Approval of drugs after good results from Phase II studies, coupled with much better designed and more intensive postmarketing surveillance carried out with the same high scientific standards that now govern Phase II and III trials, would provide better medical information and safeguards for the patient than currently exist. As seen from the L-Dopa example, neither new legislation nor new regulation is necessary to use this approach for other drugs.

A Process for Evaluating the Regulations Themselves. Both of the main drug regulation reform proposals currently before the Congress, S. 1045 (the Carter administration's omnibus bill) and S. 1075 (more limited amendments of the existing statute), contain provisions for subsequent studies of the bill's effects. This is an excellent idea, but it does not go far enough. There should be a continuing process for evaluating the impact of laws and regulations on the search for new medicines, and thus on public health. This would include research impact statements, cost/benefit analyses of new regulatory programs, and the monitoring of therapeutic progress under different regulatory regimes. Regulatory conservatism will obviously prevent new drug toxicity, but at the equally obvious cost of denying sick people the benefits of new drugs. It does not take a genius to see the high costs of forgoing the prevention of 10,000 preventable U.S. coronary deaths a year for, say, three years—the time for which the beta-blocker alprenolol has been approved for this use by Sweden's stringent regulatory system. Costs of this kind and magnitude must be taken into account in reforming drug regulation here.

THERE IS a real risk that the entire system for developing new drugs in the United States may even now be grinding to a halt. It could soon be too late to make the sorely needed changes, if it is not too late already. Reform of drug regulation is indeed becoming ever more a life and death matter. ■

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THE WEBER CASE

In its opinion in *United Steelworkers of America and Kaiser Aluminum & Chemical Corporation* v. *Weber*, the Supreme Court, dividing five to two, ruled that Title VII of the Civil Rights Act of 1964 permitted employers and unions in the private sector to adopt collectively bargained affirmative action plans for the purpose of eliminating manifest racial imbalances in traditionally segregated job categories. The majority declined to define the limits of such ostensibly voluntary quotas, or to deal with court-ordered quotas as a remedy for proven violations of the act, or to consider the effect of Executive Order 11246 (covering government contractors). Nevertheless, the opinion has been extravagantly hailed as an unqualified endorsement of "affirmative action" in employment. To appraise that assessment, it is necessary to examine the opinion and its background in some detail.

The Facts and the Issues

Kaiser opened its plant in Gramercy, Louisiana, in 1958. By the 1970s, blacks constituted approximately 39 percent of the labor force in the Gramercy area, but less than 15 percent of the plant's work force and less than 2 percent of its craft workers. Kaiser had hired only craftsmen (carpenters, electricians, and machinists, and so on) with five years industrial experience—experience rarely possessed by blacks, who had previously been excluded from craft unions. As a result, Kaiser's efforts to recruit trained black craftsmen—although apparently bona fide—had been largely ineffective.

In 1974, Kaiser addressed that recruitment problem in its collective bargaining agreement with the United Steelworkers of America. That agreement provided for a new in-plant craft training program at Gramercy (as well as at Kaiser's other aluminum and container plants). At least one black was to be admitted to the training program for every white until the percentage of black craft workers equalled the percentage of blacks in the Gramercy work force, or 39 percent (a goal that the company estimated would be reached in thirty years). Black and white applicants were to be chosen on the basis of their relative plant seniority within their racial group. Since the plant employed more whites than blacks and since whites had, on the whole, more seniority, the separate racial seniority lines appeared to discriminate against whites.

Kaiser, a contractor with the federal government, gave three reasons for adopting this program: (1) pressure from federal contract compliance officers, (2) fear of litigation by blacks, and (3) a belief that such programs advanced national policy.

In 1974, Brian Weber, a white man, was turned down for three skilled training programs at Gramercy even though he had more seniority than two successful black candidates. He then brought a class action challenging the 50 percent minority admission quota under Title VII. He won in the federal district court, which enjoined the use of race as a criterion for admission to the program, and in the Court of Appeals for the Fifth Circuit, with Judge

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Double Talk and Double Standards

Bernard D. Meltzer

Wisdom dissenting. That court emphasized and sustained the district court's finding that Kaiser had not been guilty of any past discrimination at its Gramercy plant. The case then came to the Supreme Court.

On the surface, *Weber* presented the question of how "equality" had been defined by Congress in the 1964 Civil Rights Act. But not far below the surface were larger and more contentious issues. Did intervening conditions, including the Supreme Court's own decisions, warrant a change in the mandate or the policy of Congress? If so, was it proper for the Court, rather than Congress, to make that change?

Justice William Brennan, who wrote the Court's opinion, purported to deal only with the narrow issue of construction. Chief Justice Warren Burger and Justice William H. Rehnquist (who wrote the principal dissent) objected that, under the guise of construction, the Court was rewriting the mandate of Congress. When basic clashes of values lie behind constructional problems, such protests are as familiar as "Kill the umpire." Nevertheless, in *Weber*, the protest has extraordinary power.

. . . the Court's argument is so weak that it is embarrassing to subject it to conventional legal analysis.

Indeed, the Court's argument is so weak that it is embarrassing to subject it to conventional legal analysis. But such analysis is a necessary first step in an effort to understand the limitations and implications of the Court's decision.

The Opinion of the Court

Title VII outlaws all employment discrimination against an individual on grounds of race. Thus, the statute's central provision makes it unlawful

> for an employer—
>
> > to fail or refuse to hire or to discharge *any individual*, or otherwise to discriminate against *any individual* with respect to his compensation, terms, conditions, or privileges of employment, because of *such individual's race*, color, religion, sex, or national origin . . . [emphasis added].

Another provision dealing specifically with on-the-job training programs also barred employers or unions from discriminating against any "individual because of his race. . . ." In the light of those provisions, the Court's opinion virtually conceded that Weber's position was supported by a literal interpretation of the Civil Rights Act. But it rejected such an interpretation as incompatible with the spirit of the act and the intention of its makers. Brennan supported this position with these reasons: Congress's primary purpose had been to open to blacks jobs from which they had traditionally been barred. *Weber*'s proposed interpretation was unacceptable because it would prohibit effective steps by private firms to accomplish that purpose. Quoting from the late Senator Hubert Humphrey, the justice observed that it would

> be ironic indeed if a law triggered by a nation's concern over centuries of injustice and intended to improve the lot of those

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who had been "excluded from the American dream for so long" were also to be the first blanket prohibition of all voluntary private, race-conscious efforts to abolish old patterns of racial segregation and hierarchy.

Brennan found a central justification for his position in section 703(j) of the act, which provides that nothing in Title VII shall be interpreted to *require* any employer to grant any preferential treatment to any individual or to any group because of a racial (sexual, et cetera) imbalance in an employer's work force. He urged that Congress's use of "require" rather than the phrase "require or permit" shows that Congress "did not mean to prohibit all race-conscious affirmative action to redress racial imbalance." Such a blanket prohibition would, he continued, ignore the fact that section 703(j) had been prompted by the concern about excessive federal regulation expressed by some legislators.

Brennan explicitly declined to go beyond the case before the Court and to delineate the scope and limits of the governing principle. Nor did his listing of those aspects of the Kaiser-USWA plan that in combination made for its legality do much to dissipate the murkiness inherent in the Court's avowedly ad hoc approach. We will look at that list below and suggest that the Court has not yet explicitly endorsed all "affirmative action" preferences even for blacks, and has ostensibly reserved for the future decisions on preferences for women, Hispanics, and other groups.

In the Court's opinion, only a brief footnote was devoted to the troublesome case of *The University of California* v. *Bakke* (1978), which had held that Title VI of the Civil Rights Act outlaws the adoption of explicit racial quotas in federally funded medical schools. Brennan dismissed that case principally on the ground that Title VI and Title VII shed no light upon one another since the former had been enacted pursuant to congressional power to condition federal expenditures and the latter pursuant to the commerce power.

This suggestion—that a different constitutional basis for the two titles implies different substantive standards for each of them—is not supported by any functional consideration. Furthermore, it ignores the fact that both titles incorporated a broad antidiscrimination principle. It is odd indeed to learn from the Court's parsimonious footnote that these two titles of the Civil Rights Act should be severed from each other, even though they had been integrally connected by the approach of all the justices in *Bakke* as well as by common language, purpose, and history. This oddity calls to mind the remark of Thomas Reed Powell (a distinguished law teacher at the Harvard Law School when Brennan was a student there) that a legal mind is one that can think about one subject while refusing to think about another subject inextricably tied to the first.

The Dissents

The core of Rehnquist's dissent is reflected in his charge that "[t]he Court eludes clear statutory language, 'uncontradicted legislative history' . . . , and uniform precedent in concluding that employers are, after all, permitted to consider race in making employment decisions." In his lengthy opinion he relentlessly documents each criticism he leveled against the majority. The power of his opinion is, in part, the power of repetition—especially the repetition of excerpt after excerpt from the legislative debates—all to the effect that under the act employers were not to be permitted (or required) to discriminate in favor of blacks or whites, that racial quotas, voluntary or involuntary, were to be forbidden. A summary cannot, accordingly, convey the force of this argument.

The power of Rehnquist's opinion came also from his clean craftsmanship in disposing of the Court's argument that the use of "required" in section 703(j) implied that some "voluntary" racial preferences were to be allowed. Rehnquist's response went like this: Section 703(j) had been designed to satisfy the bill's critics, who had urged that the act would be interpreted by courts and official agencies to require employers with racially unbalanced work forces to grant preferential treatment to minorities. There had been at that time no need to deal with truly voluntary, in addition to officially required, quotas. For the language of Title VII, as proponents and opponents of the bill both understood, plainly banned voluntary quotas. Indeed, never once during the eighty-three days of Senate debate did a speaker suggest that the bill would permit employers to

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adopt voluntary preferences in favor of blacks. It was ironic, first to label Kaiser's plan as "voluntary," when it had actually been induced by pressure from federal agencies charged with enforcing Executive Order 11246 against government contractors, and then to uphold that plan by invoking section 703(j), which had been designed as protection against employers' being forced into quota systems by government pressures. Rehnquist added the final blow by pointing to the express provision in Title VII permitting firms on or near an Indian reservation to grant publicly announced preferences to Indians living close by. He urged that had Congress wished to permit such preferences for blacks it would have used similar language.

Rehnquist's persuasive textual and historical analysis is, moreover, wholly compatible with the statute's primary purpose, as defined by Brennan—to help blacks get jobs. That end was, however, to be advanced by a particular means, by incorporating into law the equal opportunity for employment that had for so long been denied to blacks. It was clear in 1964, as it still is today, that ensuring such opportunity would help blacks enter the economic mainstream. But it was also clear that legal protection of equal opportunity for blacks could not have been enacted if whites had not expressly been accorded the same protection as blacks.

Furthermore, the broad sweep of the antidiscrimination principle had deep moral as well as political roots; equal opportunity for individuals and the irrelevance of their membership in particular racial groups—black or white—had been a classic but unrealized goal of American society. To be sure, equal opportunity, without concern for unequal conditions, could be an idle ritual. But the attack on unequal conditions was not to be based on race or to involve selective employment discrimination against "innocent whites." Instead, that attack was to be based on need or disadvantage—a criterion that cut across racial lines and that was both a better measure of inequality of condition and less troublesome, morally and politically, than race.

... the attack on unequal conditions was not to be based on race.... [but rather] on need or disadvantage—a criterion that cut across racial lines and that was both a better measure of inequality of condition and less troublesome, morally and politically....

Chief Justice Burger joined in Rehnquist's dissent, but disagreed with him on the ultimate policy question. Rehnquist had expressed distaste for racial quotas. Burger, however, endorsed as a citizen the end sought by the majority—legalization of action such as Kaiser's. His endorsement of the Court's end (without discussing the policy issues) underscored his disapproval of the Court's means, which, he suggested, were an intellectually dishonest assumption of legislative powers.

Post-1964 Developments

None of the three opinions we have touched on covered in any detail developments—judicial and executive—following the passage of the 1964 act that had generated pressures on private employers to adopt employment practices of questionable legality. Justice Harry Blackmun, in his concurring opinion in *Weber*, emphasized those pressures. Although acknowledging his "misgivings" as to whether the pertinent legislative history supported the Court's result, Blackmun found that result supported by "additional considerations, practical and equitable only partially perceived, if perceived at all, by the 88th Congress."

Presumably those considerations were related to a series of judicial decisions under Title VII and executive decisions under Executive Order 11246 (covering government contractors) that purported to require color blindness in employment decisions while exerting great pressure on employers to achieve in their work force statistical proportionality for blacks, women, and other "protected" groups. Thus, the Supreme Court in *Griggs* v. *Duke Power Co.* (1971) had barred the use of professionally developed tests—even in good faith—if they had a disproportionately adverse impact on blacks, unless the employer proved "business necessity." The Court also deferred to and legitimated the stringent guidelines of the Equal Employment Opportunity Commission (EEOC) for validating tests in which

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blacks as a group do relatively badly. The resulting burdens of validation involved such expense and difficulties that they undercut the statutory proviso designed to preserve professionally developed tests used in good faith. These impediments to employers' relying on "objective" criteria complemented rules whereby proof of statistical imbalances in a work force could alone lead to back-pay liability to large classes of employees as well as to reputational injury to those found guilty of "discrimination."

The "moral" of all this was clear to employers: There was safety in numbers or in some kinds of numbers—that is, numbers tending to show statistical parity for blacks would not only reduce the risk of charges of or liability for statistical imbalances, but would also be helpful should an individual employee charge particularized and intentional discrimination by the employer.

While these pressures for race-conscious hiring were emerging, the Supreme Court continued to proclaim the color-free theme of Title VII. Indeed, in *Griggs* itself, the Court had announced that the statute outlawed all racial criteria and that it proscribed all "discriminatory preference for any group, minority or majority." Thus the Court purported to bar an employer from using race-conscious or quota hiring in order to avoid the statistical imbalances that might well be the road to costly litigation and liability.

A similar ambivalence regarding equal opportunity and equal outcomes for groups developed under Executive Order 11246. That order required government contractors to commit themselves both to "affirmative action" and to a comprehensive nondiscrimination obligation. But the administration of the order emphasized results. Equality of opportunity insofar as it meant race-free decisions was superseded by, or measured by, equality of outcome. An employer's performance and compliance were measured by the representation of minorities in his work force and in the population—or some population—or in some labor market. Compliance agencies pressed contractors for goals and timetables or "commitments" even without any showing of past or present discrimination. Despite the pressure for racially oriented decisions exerted by these ill-defined extra-statutory requirements, the regulations contained the usual contrapuntal disclaimer that the use of goals and timetables "is not intended to discriminate against any applicant or employee because of race, color, religion, sex or national origin."

These developments, despite their ambivalence, generated expectancies of, and constituencies for, continued "reverse discrimination." Furthermore, some disinterested observers supported such programs on the ground that individual blacks had suffered because of their race and that, accordingly, they should be helped by compensatory programs that were racially oriented. Still others dismissed any legal or moral problems involved on the "practical" ground that, in the real world, curtailment or dismantling of the policy of selective discrimination would threaten social peace.

Blackmun's Opinion

In *Weber*, Blackmun scarcely mentioned such broad issues (some of which were discussed in *Bakke*). He emphasized the plight of business subject to contradictory commands from the government, stating:

> The broad prohibition against discrimination places the employer and the union on . . . a high tight rope without a net between them. If Title VII is read literally, on the one hand, they face liability for past discrimination against blacks, and, on the other, they face liability to whites for voluntary preferences adopted to mitigate the effects of prior discrimination against blacks.

Stressing that alleged dilemma, the government in *Weber* argued that employers and unions "who had committed arguable violations of Title VII" should be free to make "reasonable responses" without fear of liability to whites. Blackmun favored that approach, which would have focused on the employment practices of a particular firm. Nevertheless, he joined in the Court's opinion because in the end he found that employers would have substantially the same leeway with respect to racial preference under both approaches. Moreover, he perceived "strong considerations of equity" supporting the majority's approach of permitting preferential treatment designed to remedy

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the effects of societal discrimination. Indeed, adding insult to injury, he protested that Mr. Weber seemed "unfair" in challenging Kaiser's efforts to rectify historic discrimination—even though the Court had upheld a similar protest in *Bakke*.

In any event, the "arguable violation" approach favored by Blackmun and the government suffers from fundamental and manifest difficulties. It is needed only if Title VII in general bars all employment discrimination—in favor of or against blacks. But if the statute is read in that way, it is not apparent why arguable discrimination against members of one group should justify actual and undeniable discrimination against members of another group. All of Blackmun's subsidiary arguments beg that question and seek to convert a broad anti-discrimination principle into a question of whose ox is gored (to use Alexander Bickel's phrase). This is not to deny that under Title VII —among other regulatory contexts—employers have been faced with the risk of being damned if they do (engage in reverse discrimination) and damned if they do not. Such dilemmas are, of course, undesirable. Nevertheless, in resolving them in the Title VII context, the critical point is that that statute was designed to regulate employers and to protect employees. And if a choice must be made between a quieter life (or government contracts) for employers and the abrogation of statutory protection for some classes of employees, nothing in the statute suggests that the employees' interests should be sacrificed.

Finally, the employer's alleged dilemma is often a false one—because future affirmative action cannot wipe out liability for past violations. To be sure, affirmative action may divert attention from, and thereby avoid remedies for, past discrimination, but only at the expense of adequate relief for identifiable victims of such discrimination. Indeed, Blackmun seems to endorse voluntary quotas in part because they fuzz things up in this way. Assume for example that, after the Civil Rights Act became effective, an employer engaged in discrimination against two black employees. In order to bolster his legal position the employer grants preferences to two other blacks, who were not directly affected by the employer's wrong. The equity of such results is elusive—and when, as in *Weber*, the employer has not even been found guilty of actual discrimination, the equitable support for racial preferences surely does not grow stronger.

Such indifference regarding a link between the victims and beneficiaries of particular wrongs and remedies contrasts sharply with the sensitivity to such relationships reflected in opinions of the Supreme Court or of individual justices in cases such as *Franks v. Bowman Transportation Company* (1975) or *Bakke* (1978). Those cases suggest, moreover, that substantial constitutional questions arise from a statute that permits an employer to grant voluntary preferences to blacks but prohibits such preferences to whites. The majority of the Court was wholly silent about these interrelated equitable and constitutional questions.

"Additional Considerations, Practical and Equitable"

It is now useful to look more closely at Blackmun's general claim that "additional considerations, practical and equitable, only partially perceived, if perceived at all by the 88th Congress" support the Court's conclusion. It is worthy of emphasis that these unperceived considerations are not developments external to the structure of regulation; on the contrary they consist of the judicial decisions and executive practices that have generated great pressures for statistical parities and racial quotas, despite the resultant tensions with the statutory language and history. Blackmun's statement thus involves a reversal of roles, a painful failure to recognize whose perceptions —the judiciary's or the Congress's—should be respected in nonconstitutional cases. For Blackmun is implying that Congress failed to perceive that the judiciary and the executive would undercut the political and ethical bargain reflected in Title VII, and also failed to perceive that the judiciary, along with the executive, would generate pressures on employers to ignore the statute and to discriminate against members of some groups (including white males) in order to get protection against charges of discrimination against members of other groups (including blacks and females). Nevertheless, Blackmun finds that it is not the Court's inadequate perceptions but those of the Congress that now require a drastic and explicit

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narrowing of the antidiscrimination principle written into the statute. This change is necessary not to protect the original policy of the statute but rather to protect those whom it regulates from the conflicting pressures of contradictory policies that have been shaped by the courts, the EEOC, and the Office of Federal Contract Compliance (OFCC)—bodies that are supposed to implement the constitutional mandates of Congress.

Weber is another important step in the transformation of the . . . ideal of equal opportunity for individuals into a new program of equal outcomes for groups that is more divisive than the older ideal and fundamentally inconsistent with it.

The Court had another obvious alternative, namely, to seek to respect the language and history of the statute and to make clear that if doing so placed an innocent employer in an intolerable situation the Court would reexamine and, if need be, revise earlier decisions. For the change made by *Weber* is plainly not a response to a minor hitch, unforeseen by Congress, of the kind that often emerges as a statute is administered. On the contrary, that change goes to the roots of the bargain reached in the Eighty-eighth Congress and to the roots of our tradition. *Weber* is another important step in the transformation of the classic and widely supported liberal ideal of equal opportunity for individuals into a new program of equal outcomes for groups that is more divisive than the older ideal and fundamentally inconsistent with it.

Affirmative Action and the Court's Role

It is not possible here to review the arguments over the relationship of these competing concepts of "equality" to equity and order. What merits emphasis here is that the resolution of such questions by the Court under the guise of statutory construction strains its institutional competence. Thus the Court's opinion does not even notice some questions relevant to a disinterested and informed choice between those two concepts. And one need not romanticize the process of legislative investigation or legislative decision to recognize that litigation is as ill-suited for informing the Court regarding the pertinent questions as the Court is for resolving them. It may be useful to mention some of the pertinent questions neglected by the Court.

Is official pressure for affirmative action a substantial factor in the location of plants away from the centers of black population, with a view to avoiding pressure for the quota hiring required to redress statistical imbalance? As a consequence, are the most disadvantaged blacks being hurt by regulation designed to help them? Will the shift from equal opportunity for individuals to equal outcomes for groups undermine the consensus that was, at last, achieved in 1964? Will those all too ready to exploit the grievances of innocent whites in order to promote bigotry now be able to march under a respectable banner—equal opportunity for all? Will the fallout from *Weber* further polarize our work forces and our communities? Will it obstruct important job training across racial lines—the spontaneous on-the-job instruction of one worker by another? Will the backlash create further obstacles to legislative action necessary for programs designed to help all the disadvantaged, black and white? Will quota hiring result in significant inefficiencies, thereby retarding economic growth, to the particular disadvantage of minorities? Could a shift from individual to group "rights" be stabilized anywhere short of a transformation in the basic values of our society and in our political, legal, and economic institutions—short of a completely "quotified" society?

These illustrative questions are legislative and—in the best sense of the word—political. There is no indication that the Court even considered them. On the other hand, in answering the question presented by *Weber* without appropriate regard for Congress's mandate, the Court risks its future capacity to meet a deeply felt need for trustworthy neutrals. Finally, when the justices stray into the political thicket, it is more likely that the Court will fail a classic test for a Supreme Court opinion, that it give reasoned explanations transcending the case being decided.

Weber fails that test. Although it affects almost the entire work force, it fails to provide coherent guidance to government officials and

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private lawyers who must give day-by-day advice and to judges who must deal with a flood of litigation. The Court, as we have seen, emphasized that it was deciding only the case before it. This ostensible strategy of postponement adds still another ironic twist to a decision preceded by arguments that something had to be done to alleviate the uncertainties resulting from discordant regulations.

The Reach of the Court's Opinion

The narrowness of the opinion may, however, be more apparent than real. The distinctive elements of *Weber* that the Court stressed are in the main so unrelated to the opinion's basic argument and basic purpose that if the Court persists in its fundamental position those elements are unlikely to have any importance. Moreover, those elements are in general so ill-defined by the Court that they provide no clear basis for a limiting rule.

First, *Weber* validated quotas only with respect to "traditionally segregated job categories"—in the private sector. Since the Court did not spell out those categories, there are many unanswered questions. Do jobs remain traditionally segregated and, if so, for how long after black representation has markedly increased? Does the Court's emphasis mean that quotas may not be established for relatively new job categories, such as computer programmers, if such categories have not involved any identifiable exclusion in the past but presently involve a racial imbalance? Does "traditionally segregated" mean anything more than current racial imbalance? How are the job categories to be defined for these purposes? If, for example, the relevant rubric were "white collar jobs," computer programmers might easily fit into areas of traditional segregation; and, contrariwise, if computer programmers were a separate category that had been free from segregation. Finally, is "traditional segregation" to be determined on a national, regional, or local basis?

Apart from the confusion inherent in the "traditionally segregated job category" test, the more important question is whether that test is compatible with the Court's basic reasoning. If, as *Weber* indicates, Title VII permitted some voluntary quotas in order to avoid overregulation, it is difficult to see why their legality should depend on their being directed at "traditionally segregated categories." From the standpoint of a black job applicant who has not been the direct victim of discrimination, it is not of primary importance whether there was job segregation in the past. Furthermore, whether a racial imbalance exists in a traditionally segregated occupation or in a new occupation free from prior discrimination would appear to be irrelevant to what the Court posits to be the overriding purpose of the statute—putting blacks into the economic mainstream. Indeed, measures directed at that purpose may be especially significant in areas where jobs are being created by new technologies. A similar point arises from the potential limitation of the Court's approach to the private sector, since employment has recently been growing faster in the public sector than in the private. Conceivably that limitation might be explained on the grounds that racial quotas in the public sector would involve the government directly in racial discrimination and thus raise troublesome constitutional questions. But the Court's interpretation of Title VII as permitting "voluntary" preferences for some races attributes to the Congress the same kind of discrimination on grounds of race.

Another apparent potential limitation on the employer's freedom to adopt "voluntary" preferences may be implicit in the Court's repeated statements that the Kaiser quota had resulted from collective bargaining. It is, however, difficult to find any basis for giving legal significance to that fact. Furthermore, to do so would run counter to *Alexander* v. *Gardner Denver* (1974) where the Supreme Court observed that Title VII protected individual rights against collective bargaining and the power of the majority. Finally, collective bargaining covers less than 25 percent of the work force. If the Court's approach is sound, it would be bizarre to confine it to such a small fraction of the economy.

The Court also noticed (1) that the Kaiser plan did not absolutely bar the admission of whites and (2) that the plan was a temporary one, operating only until blacks in craft jobs at Kaiser reflected the ratio of blacks in the local work force. Again, it is difficult to fit those factors into the Court's basic argument.

Although whites were not disqualified from Kaiser's training program, the places allotted to

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blacks—50 percent—exceeded their ratio in the local labor force. Even if one accepted the dubious and unhealthy premise that, without discrimination, employment in different plants would reflect ethnic proportionality, the Kaiser plan called for "overrepresentation" of blacks in the training program. Plainly, then, the plan was presented not as a prophylactic against future discrimination by Kaiser, but as a catch-up remedy for past discrimination by society. If such a "voluntary" remedy is favored or tolerated as a way of getting blacks into the economic mainstream, why should the law limit an employer who wishes to help blacks catch up even more quickly by barring whites altogether until a given statistical goal is reached? Similarly, if an employer can lawfully give blacks a quota higher than their ratio in the local labor force—without any consideration of relative skills—why should an employer who has achieved statistical parity in his own plant be barred from continuing his preference as a means of compensating for still unremedied "societal discrimination" elsewhere? Since the Court does not require guilt on the part of the employer as a condition of his granting racial preferences temporarily, the Court is allowing him to remedy societal discrimination. Why should his privilege end when he has achieved statistical parity but the rest of society has not?

The Court's emphasis upon the legislative history's focus on blacks and their economic plight may imply another limitation on voluntary quotas: that is, they may not be lawfully applied to white women, Hispanics, and members of other "protected groups." To be sure, the Court's emphasis on voluntarism and on traditionally segregated job categories, as well as Blackmun's emphasis on safety nets for employers, could be invoked to validate "voluntary" preferences designed to redress "underrepresentation" of such groups. Within the framework of *Weber*, one would expect that result. But such preferences could be "distinguished" on the basis of other themes in the Court's opinion.

Even if preferences to other groups are permitted, there will be a cluster of additional complexities arising from charges that blacks are being excessively preferred at the expense of Hispanics, women, or Vietnamese refugees—or from charges that run the other way. It is understandable that the Court, in its *Weber* opinion, did not attempt to illuminate those difficulties.

Only one more uncertainty can be mentioned here. What kind of an affimative action plan will protect an employer in a *Weber* situation? Does the plan have to be in writing? How detailed and systematic must it be in order to distinguish lawful "reverse discrimination" under such a plan from ad hoc preferences for blacks previously forbidden by the Court? Finally, if the OFCC should openly order an employer to adopt specified affirmative preferences for blacks, would such a plan, because it was "involuntary," be beyond the protection of *Weber*?

Certainty through Uncertainties—The EEOC Guidelines

The uncertainties mentioned above might limit the use of "voluntary" preferences. But they will also in many instances protect employers who act in accordance with EEOC guidelines or affirmative action programs under the executive order. For Title VII seeks to insulate against damages liability firms that in good faith have conformed to and relied on any written interpretation by the EEOC. And under the EEOC's guidelines issued shortly before the Supreme Court's decision in *Weber* and embodying the government's position urged in that case, an employer is protected against damages liability if he engages in reasonable affirmative action in order to redress statistical disparities or to carry out an affirmative action plan pursuant to the executive order covering government contractors. Given the looseness of the Court's rationale for "reverse discrimination," reliance on almost any official guideline sanctioning such discrimination would appear to be in good faith. Hence, the Court has not only rewritten Title VII but—as to damage actions—has by its temporizing facilitated further incursions on that act by the combined operations of the OFCC and the EEOC. Thus, the OFCC's pressures may propel employers into adopting "voluntary" quotas (for women as well as blacks) pursuant to affirmative action programs "suggested" by officials who have chosen to read the *Weber* opinion as a blanket endorsement of affirmative action (as that term is understood by agencies better known for

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their zeal for "results" than for their commitment to equal opportunity or their disinterested interpretation of Supreme Court opinions). *Weber* is thus likely to encourage "antidiscrimination" agencies to step up their pressures for discriminatory quotas. And *Weber* is likely to lead to the validation of many of those quotas. As to others, the guidelines—at least in damage actions—will tend to protect employers. Thus the Court, the EEOC, and the OFCC (despite doubts as to the constitutionality of the powers asserted by the OFCC) will interact to protect employers who are pressed into quotas on the ground, among others, that quotas are the voluntary result of self-study. The irony—noticed by Rehnquist—of labeling such quotas voluntary will increase if the club of the procurement power is wielded more vigorously. If it is wielded with more candor, or even less circumspection, the Court may, of course, reexamine its concept of voluntariness.

IN *WEBER*, only Blackmun suggested that intervening judicial and executive action made the issue before the Court more complex than what was the original meaning of Title VII of the 1964 act. Nevertheless, his answer, like the Court's, failed in my view to respect the clear mandate of Title VII and contravened what James Madison called the fundamental principle of our Constitution—separation of powers. That view will, of course, be challenged by those who see the Court as free to substitute its values and perceptions for those of Congress, especially when the Court goes their way. But even those more concerned with results than rationale are, I believe, likely to agree that *Weber* lacks the clarity, the candor, the coherence, and the convincing power that are appropriate for the work product of the Supreme Court of the United States. Those qualities are, indeed, usually the first casualties of judicial forays into the legislative thicket. ■

... Weber lacks the clarity, the candor, the coherence, and the convincing power that are appropriate for the work product of the Supreme Court of the United States.

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nologies directly. For example, the federal government might announce that it is willing to buy a million barrels per day (or the equivalent) of liquid or gaseous fuels produced from coal or shale at some fixed price above the current market price. But it should not itself pick a particular process or demonstration plant or get involved in technological decisions or production activities. Instead, it should provide an incentive for the private sector to pursue the development of the most cost-effective technologies.

It is private industry, not the government, that is in the best position to determine which new technologies are most economical and most promising, and to manage the commercialization of those technologies. In addition, private industry is much better able than government bureaucracies to drop a particular project should it turn out that the technology is not as promising as it appeared. By choosing to subsidize a project in a particular congressional district and creating a government bureaucracy to manage the project, we inevitably create a set of political forces that makes termination of the project very difficult. Nor is there any reason to believe that the personnel in government agencies are in a particularly good position to evaluate the many proposals always put forward when government subsidies become available.

We should never repeat the mistake made in our breeder reactor program by giving the government a primary role in choosing among programs or managing any particular program. By using broad price and purchase guarantees we can avoid committing ourselves to a technology that appears less and less desirable as time goes on.

To the extent that the government does participate in commercialization, its role should be strictly limited to the most efficient subsidization of alternative energy supplies in general, rather than particular technologies and programs. But we must recognize that this "second-best" policy will still be far more costly to the American public than the "first-best" policy, which largely eliminates the need for government participation in the production of energy in the first place. ■

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REGULATING CHRYSLER OUT OF BUSINESS?

Kenneth W. Clarkson, Charles W. Kadlec, and Arthur B. Laffer

WHEN REGULATIONS to protect the environment, improve safety, and meet other national goals were first proposed in the mid-1960s, the costs of complying with those regulations were widely assumed to be far less than the expected benefits. In recent years, that assumption has been challenged by experience and by the first empirical efforts to quantify at least the direct costs of regulatory compliance to the nation's economy.

What is not yet fully realized, however, is that regulatory requirements that appear uniform and "fair" may substantially alter the competitive structure of an industry because the burden tends to fall disproportionately on smaller firms. Thus the inadvertent result may be to cripple the smaller firms and concentrate market share in the hands of the biggest and wealthiest corporations. The automotive industry, a product of more than seventy-five years of development and a bulwark of the U.S. economy, provides a primary example of these effects of regulation on competition.

In 1965, the automotive industry was singled out by Ralph Nader for producing "unsafe" cars. The next year Congress responded to Nader's exposé by passing a law authorizing the Department of Transportation to regulate auto design and manufacture, the primary purpose being to increase auto safety. Less than five years later, pollution became a primary societal concern, leading to new laws whose primary purpose was a 90 percent reduction in automotive emissions. Then, in 1974, a group of oil-producing countries, acting as a cartel, raised the price of oil fourfold. The Congress, perceiving an oncoming "energy crisis" in the United States, reacted by passing a law regulating energy consumption—including in it mandatory minimum automotive fuel-efficiency standards.

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The Regulatory "Tax"

It will illuminate our analysis to think of regulations, from the perspective of the firm, as a form of taxation. The government, after all, once it decided that the national interest would be served by a cleaner environment, safer work place, and fuel-efficient cars, could have then appropriated funds out of the Treasury to gain these objectives. Instead, to a large extent, it has chosen the course of requiring firms to install the equipment or take the design action necessary to comply with a regulatory mandate. To the extent that the requirements are effective, the companies commit resources in ways other than they would have in response to demands of the marketplace. (That, in this context, is what "effective" means.) The expenditures are made as a condition of staying in business and are therefore viewed properly as

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a tax payment: the economic value of compliance *to the firm* is equivalent to a receipt for taxes paid.

To take this approach is not to argue that expenditures required to comply with regulations produce no benefits, any more than recognizing income taxes as a cost of doing business argues that government programs funded by those taxes are worthless. The treatment of regulatory burden as a tax is perfectly consistent with the fact that a reduction in auto emissions leads to a cleaner environment, and the further fact that a cleaner environment has economic value.

Nevertheless, whatever the other effects of regulation, it does act as a tax. In both the short and long run, real prices to consumers will rise, while payments to resources will fall. Individual firms, when faced with the costs of complying with the regulations, will not be able to pass on more of those costs than what is permitted by the competitive response in the industry. (This point is of major importance for our analysis.)

Of course, the form of the regulatory tax is as important as its existence. If the regulation imposes an ad valorem burden—that is, imposes costs directly proportional to the value of the company's output—it is equivalent to a uniform sales tax. If the regulation imposes a per unit burden, it is equivalent to a tax bearing most heavily on those units with the least value added. Finally, if the regulation imposes a fixed burden without regard to the quantity of output, it is equivalent to a lump-sum tax. Given generally similar unit values of output, such a uniform requirement for each firm in the industry will impair the performance of small firms relative to large firms. That is, the lower the value of the output, the higher the lump sum is in relation to that value.

The Tax and Chrysler

These distinctions are far from being purely academic. For example, federal regulations designed to reach national health, safety, environmental, and fuel-efficiency objectives have been assumed to affect individual auto firms in the same way as a flat rate tax affects individual taxpayers. That is, they are assumed to take a given—uniform—percentage of income from each company. But, for the auto industry, this assumption is incorrect: as a rule, regulation has hurt the smaller full-line firms more than the larger ones. Chrysler Corporation's current predicament is properly viewed as an example of the unintended effects of increasingly more stringent regulation. The "lump-sum" effect of this regulation is furthered by the fact that the government forbids the auto companies to pool their research, requiring each company to make roughly the same (lump-sum) research expenditures.

Chrysler Corporation's current predicament is properly viewed as an example of the unintended effects of increasingly more stringent regulation.

As a hypothetical example, imagine that it costs all auto firms $5,000 to develop a device to control emissions. If the cost of producing each device is $10 and if the smaller firm installs the device on 100 units (cars) and the larger company installs it on 300 units (cars), the investment and extra production costs are $6,000 for the smaller firm—$5,000 + (100 × $10)—and $8,000 for the larger firm—$5,000 + (300 × $10). The smaller firm must receive $60 per device to recover these costs ($6,000 divided by 100), while the larger firm needs to receive only about $27 ($8,000 divided by 300).

Plainly, the larger firm has an advantage—its unit costs are lower. Competitive forces dictate, however, that the per-unit charge levied in an effort to recoup the investment and extra production costs be approximately the same for each auto company. Thus, if the larger firm charges its customers the price that recovers the $27, the smaller firms will have to charge approximately $27—or less than half the $60 they actually expended. It is a point of prime importance that, throughout the last decade, when regulators asked U.S. auto firms to estimate the cost of manufacturing catalytic converters, General Motors' estimates were consistently well below Chrysler's. This led regulators to disbelieve Chrysler when in fact both firms may well have been correct in their estimates.

Let us take the example a step further. If the smaller company spends $5,000 for R&D and the larger one spends much more, say

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$12,000, the smaller firm's cost stays at $60 per unit while the larger firm's cost rises to $50. General Motors, the largest U.S. auto firm, has in fact consistently spent more than Ford or Chrysler on R&D for government-mandated emission controls. This greater expenditure permitted General Motors to pursue separate research tracks during the period when emission standards were evolving. Chrysler, with its more restricted financial resources, pursued multiple tracks as well. Indeed, its generic engineering advantage yielded a "lean-burn" engine system that would have satisfied emission standards slightly less stringent than actually proposed. But the government's final standards eliminated the lean-burn engine as a viable alternative, forcing all firms to employ the catalytic converter.

This governmental decision emphasizes the important point that the specific standard chosen as well as the form of the regulation may have substantial effects on competition in the industry. If policy-makers had chosen the 1979 automobile emission standards as their goal, Chrysler's market position would have been strengthened rather than weakened (since the lean-burn engine system could have met the 1979 levels without a catalytic device) and Chrysler would have been able to capture the benefits of leasing or selling its lean-burn technology. Faced with the actual final emission standards for 1980 and thereafter, it had no choice but to develop the catalytic device.

Things are made worse by the fact that, beginning in 1980, U.S. auto firms will not be allowed to count the cars they import, even if they produce those cars themselves, to help achieve the fleet-wide average fuel efficiencies required by the regulations. For the domestic industry's smaller firms, the rule against counting imports will force (lump-sum) fixed investment in domestic facilities, shifting the nature of the regulatory tax to place a greater burden on smaller firms. And for all the firms, the rule will reduce the benefits of economies of scale.

The Cost of the Tax

The companies have provided the Department of Transportation with estimates of their fixed costs for complying with existing emissions, safety, and fuel-economy standards over the eight years ending with 1985. The estimates are staggering: $800 million a year for Chrysler, (65 percent for fuel economy, 30 percent for emissions, 5 percent for safety), $1,000 million a year for Ford, and $2,000 million per year for General Motors—in 1977 dollars. Moreover, the expenditures required are proportionately greater for Chrysler than for Ford or GM.

SALES, PROFITS, AND ESTIMATED REGULATION-MANDATED COSTS FOR THE BIG THREE

	Chrysler	Ford	General Motors
Cost of regulation (millions)[a]	$800	$1,000	$2,000
Cost as percent of sales	7.0	4.2	4.6
Cost as percent of aftertax profits	496.9	112.7	68.5
Cost per car produced	$550	$340	$345
Net sales (millions)[b]	$11,390	$23,969	$43,430
Aftertax profits (millions)[b]	$161	$887	$2,918
Number of cars produced (thousands)[b]	1,451	2,933	5,782

[a] Average for 1978-85.
[b] Figures are for 1977 North American operations.

A glance at the table shows that Chrysler's estimated regulation-induced investment is five times its profits and 7 percent of its sales for 1977, while Ford's is greater than its profits and 4.2 percent of its sales for that year. Only for GM is current profit greater than estimated regulatory cost (though equal to 4.6 percent of 1977 sales). This suggests strongly that the tax rate imposed on Chrysler by government regulations is roughly 50 percent greater in relation to sales than the tax rate imposed on either Ford or GM.

Moreover, the estimated costs of the regulations are more than $200 per car (60 percent) higher for Chrysler than for either Ford or GM. The source of the disparity, by and large, is the fixed-cost component of the R&D and the basic retooling needed to attain compliance. For Ford, the tax rate appears to be roughly the same as for GM, even though Ford is the smaller firm. The cost of complying with the regulatios is approximately $340 per passenger car for Ford and $345 for GM.

By their very nature, regulations also reduce diversity, each requirement in turn elimi-

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nating product features previously available. The more aspects of a product that are regulated, the narrower the distribution of choices around the "average" or "standard" product. Thus, new regulation reduces opportunities for firms to specialize in providing unique combinations of features to the consumer. Indeed, if the government required absolute standardization of a product, in time all firms producing that product would merge into the one most efficient firm. If the government dealt out a single blueprint of a standard auto and required all autos to be built to those specifications, all specialty firms would be forced to dissolve (it would be illegal, for example, to manufacture Checker Cabs). If a product could not be differentiated (whether by quality, warrantee provisions, or whatever), price alone would be the consideration, and the firm that could stamp out the standard auto most efficiently would drive all others out of business.

Different auto firms exist because firms cannot at all times and in every way be superior to all other firms. Even physically flawless and intellectually superior individuals, for example, would have trouble competing with a blind person in speed-reading Braille. Similarly, an auto firm may concentrate its resources on producing the greatest number of automobiles at the lowest price; but smaller firms can still compete by concentrating their resources on developing specialty vehicles, superior styling, greater durability, engineering excellence, and so forth. Obviously, Ford and Chrysler are not small firms—but they are smaller than GM, and they have thus aimed more at specialized sub-markets and less at the market as a whole. But, by its very nature, government regulation increasingly has been herding all three toward a standardized product for the mass market, inadvertently and unconsciously undermining Chrysler's advantages (and Ford's).

. . . government regulation increasingly has been herding all three toward a standardized product for the mass market, inadvertently and unconsciously undermining Chrysler's advantages (and Ford's).

Our Scenario

While it is impossible to predict the final long-run effect of these regulations, it is clear that there will be fewer motor vehicles produced, that some real resources will go to other industries, and that users of automobiles will pay higher prices. To try to measure the potential impact on the industry and its individual firms, we set up a simulation—a future scenario. Let us explain it briefly.

In order to calculate the effect of the new requirements, assumptions had to be made about company responses to the regulations—especially those involving pricing—and about the way the consumer will react to price changes. Essentially, we made two assumptions about pricing. First, we assumed that the Big Three auto manufacturers compete with each other, partly on prices, so that no one company will raise its prices much more than any other company—and, specifically, so that Chrysler will not raise its prices significantly more than GM or Ford. Second, we assumed that when prices go up, the number of units sold (both by the industry and by the firm) goes down *correspondingly*, so that overall sales revenues do not change. (In economists' terms, there is a unitary price elasticity of demand.) This assumption simplifies our calculations and is supported by numerous studies of the automobile industry.

Now, obviously, if the number of units sold goes down, the manufacturer will make fewer units, which (all other things being equal) will reduce total costs of production. For simplicity's sake, we assumed that the amount saved by making fewer units balances the increased variable cost per unit sold (the increased variable cost, that is, mandated by federal requirements), so that the total variable cost of manufacturing the cars—the "cost of goods sold"—does not change. In fact, what is saved by cutting production does *not* offset the increased production costs per unit so that this understates the effects of the requirements, but it makes the figures much easier to work with. Even if the effects are understated, they are still far too large to be happy about.

According to our assumptions, then, when Ford or GM or Chrysler tacks on price increases because of federal requirements, say $350 per car each year, the company will get no addi-

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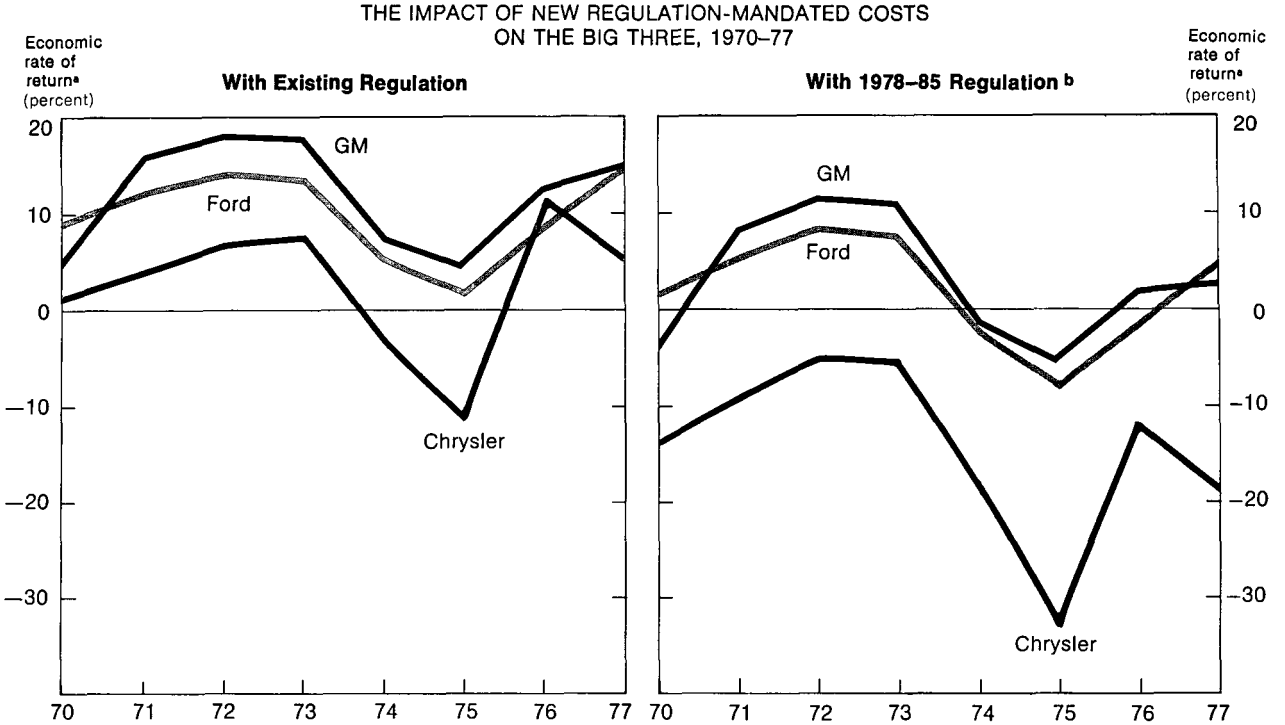
THE IMPACT OF NEW REGULATION-MANDATED COSTS ON THE BIG THREE, 1970–77



[a] Economic rates of return were calculated from Securities and Exchange Commission 10-K data for the firms' world-wide operations, using the procedure detailed in Kenneth W. Clarkson, *Intangible Capital and Rates of Return* (American Enterprise Institute, 1977).

[b] Adjusted to include estimated regulation-induced costs of $800 million a year for Chrysler, $1 billion for Ford, and $2 billion for General Motors.

tional total revenues (because units sold will go down) and have no additional cost of goods sold (because the decline in number of units sold will balance the increased variable cost per unit). The only change on the company's books will be the increased investment in plant and machinery necessary to comply with the new requirements—*if the $350 per car covers the cost of compliance.* If it does not—if it costs Chrysler $550 to comply and if only $350 can be tacked on to the price—then Chrysler's profits go down substantially and may disappear, or worse. On the other hand, if Chrysler raises its prices by $550, and the other companies raise theirs by $350, Chrysler's sales go down, and its profits may disappear, or worse. No matter which of the probable courses of action is followed, all three firms, with profit not increasing and investment going up substantially, will find their rates of return (profit divided by investment) going down.

There is, of course, a possible way out of the dilemma. If GM and Ford based their price increases on what Chrysler needed (that is, if they raised prices by $550), then Chrysler would maintain its market share and might still show profits. There would, however, still be a differential effect of the regulations. Chrysler might be neither better nor worse off, but GM and Ford would be made better off relative to Chrysler. And, of course, in the real world, GM and Ford do *not* make their decisions according to what Chrysler needs.

It should be emphasized here that traditional accounting statements do not present fully accurate pictures of the impact of regulation on profits and rates of return. It is more appropriate to use an economic model with price-level adjustments and R&D expenditures capitalized. Because capital is allocated in the marketplace according to perceptions of probable rates of return into the indefinite future, and because "accounting rates of return" are merely snapshots picturing the financial condition of the company at discrete time intervals, adjusting these accounting snapshots, smoothing them out, provides a better view of economic reality. This view is the one we want to use. So, in our simulation, we calculated the economic rates of return on net worth for the three firms for 1970–77, smoothing out cyclical variations, and then used these figures for projecting

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the impact of regulation for 1978–85. It should be noted that this is a period in which the firms anticipate major additions to capital outlays for general research and tooling in order to comply with the mandated federal regulations.

General Motors, with its incremental (government-mandated) investment of $2 billion a year, shows an average economic rate of return of 12.1 percent without this $2 billion annual outlay and 3.3 percent with it. The difference is 8.8 percentage points. Ford, with its incremental (government-mandated) investment of $1 billion per year, shows an average economic rate of return of 9.9 percent without additional regulation and 1.9 percent with additional regulation. The difference is 8 percentage points. Chrysler, with its incremental (government-mandated) investment of $800 million per year, shows an average economic rate of return of 2.6 percent a year without additional regulation and −13.8 percent with additional regulation. The difference is 16.4 percentage points.

What Does It All Mean?

The results suggest that the adverse effects of government regulation on Chrysler are extraordinary—both in absolute terms and relative to Ford and GM. Bad years in particular are accentuated, as regulation-induced investment expenditures remain high, while sales and profits fall below average. Thus, while regulation of the auto industry depresses the profitability of all firms (which in itself significantly diminishes the ability of small firms to compete), it further acts against the smaller firms by assuming they fit the mold of the largest firm.

The sheer magnitude of the cost of compliance with the higher standards scheduled to take effect in the years through 1985 threatens substantial dislocations throughout the industry, with the effect falling disproportionately on Chrysler and (to a smaller extent) Ford. The final stages of emission-control standards will have to be met in this period and the most dramatic of the fuel-efficiency standards will be faced in the year 1985, when the National Highway Traffic Safety Administration (NHTSA) is directed by law to require an increase in the average fuel economy of new cars to 27.5 miles per gallon. Our study suggests that Chrysler may not survive as a full-line auto manufacturer. Moreover, unless there should be a burst of real economic growth in the 1980s, Chrysler would have little chance of raising needed capital, given the negative rates of return on investment implied by our analysis.

Ford's viability as a full-line auto manufacturer will also be impaired, especially given that its current profitability arises largely from its foreign operations. In commenting on the standards on December 11, 1978, Ford Motor Company observed, "We believe that 27.5 mpg would press us to the limit—and our financial resources are neither the largest or smallest in the industry." Ford also pointed out the fallacy of NHTSA's findings that the standard is economically practicable "for the industry as a whole": it is not "the industry" but individual companies that must meet the standards, and the financial resources of General Motors are not available to other firms.

Thus we conclude that there will be an undesirable rise in concentration in the U.S. auto industry as a result of the regulatory burdens imposed on the industry over the eight years ending 1985, with General Motors dramatically increasing its relative position. But even as GM expands its market share, its average economic rate of return will tend to fall well below its average for the ten years ending in 1977—unless real prices of automobiles substantially increase. This could eventually lead to elimination of low-profit model lines and to a consequent reduction in choices available to the American consumer.

The smaller the producer, all other things being equal, the greater the effect of the safety, emission, and fuel-economy standards. That is, these regulations, *though uniformly applied,* significantly favor the largest manufacturers. Moreover, as the regulations grow tighter, the payoff goes more and more to economies of scale, and less and less to engineering know-how or product differentiation. With profits at $161 million a year and the estimated costs of regulation at $800 million a year, it is no wonder that Chrysler is hurting. And if Chrysler has been trying intelligently to carve out a market for itself as number three, by some means other than GM's economies of scale (which are not available to it), then Chrysler's problems are the inevitable result of regulations that place a premium on being like GM. ■

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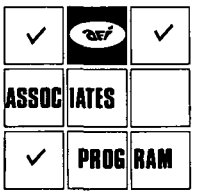

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Putting the Skids to Meals on Wheels

Michael Balzano

"RESOLVED . . . that in recognition of the selfless service performed, the President is hereby authorized and requested to issue a proclamation designating the week of September 16 through 22, 1979, as 'National Meals-on-Wheels Week'. . . ." With these words, the Congress prepared to celebrate the twenty-fifth anniversary of a typically American phenomenon.

But only a few weeks earlier, HEW's Administration on Aging (AoA) unveiled draft regulations for a new federal home-delivered meals program which, if left unchanged, threaten to drive meals-on-wheels right off the road.

Some birthday present! By any standard, these thousands of neighborhood programs constitute the very model of what has always been valued most in this country: tens of thousands of volunteers identifying a genuine community need, amassing private resources, and meeting that need—with a minimum of bureaucratic fuss and a maximum of effective service. Every day for twenty-five years now, and often twice a day, these local, private, nonprofit programs deliver hot meals (and often essential ties with the outside world) to the homebound. Most of them are old—but they need not be sixty years of age or older. Many pay some or all of the cost of the meals; others pay none. Local churches and charities make up the deficit. The programs are tailored to virtually individual situations—and apparently they work.

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In 1972, responding to no less worthy a need but quite a different one, Congress amended Title VII of the Older Americans Act to authorize a so-called congregate nutrition program. These programs serve a hot meal to senior citizens (sixty and over) five days a week in a social—congregate—setting. There is no means test or charge for the meals; voluntary contributions are accepted. Last year these congregate centers served some 500,000 meals a day at an annual cost to the taxpayers of more than $300 million. The federal grants go to state agencies which put up 10 percent of the total costs; they in turn channel the funds through area agencies on aging which create federal programs in the form of nonprofit entities to run the centers.

So, for about six years now, there have been two nationwide networks providing meals to the elderly, each with a legitimate, different, and apparently complementary purpose: voluntary meals-on-wheels programs serving the homebound and federal Title VII programs serving the physically mobile. The one was a citizens' effort, locally designed, flexible, and privately supported; the other, necessarily encumbered by federal regulation ranging from the nutritional content of the meals to equal opportunity requirements for the hired staff. The one represented no appreciable drain on the U.S. Treasury, the other a considerable one.

In 1978, Congress began debating the creation of a national, federally funded, home-delivered meals program. It was principally concerned with the nutrition needs of the homebound elderly and saw in meals-on-wheels a logical vehicle for getting the job done.

The legislation was supported by both the National Association of Title VII Project Directors, representing existing federal grantees, and by the National Association of Meals Programs (NAMP), representing a number of meals-on-wheels programs. But the two groups disagreed on how the funds should be channeled. The Title VII directors argued that their network of congregate centers should operate the federal meals-on-wheels services—with the private programs participating only under the authority of Title VII grantees, not as direct recipients of federal grants.

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NAMP's case, in contrast, was that the local voluntary programs were already in place, had a proven track record, needed money to meet a growing demand with which charitable contributions were not keeping pace, and ought to be eligible to receive federal grants. They should remain reasonably autonomous, free of burdensome federal regulations, and serve as conduits —draining off almost nothing in overhead—for federal aid to those who need it. What NAMP had in mind was a partnership, not absorption.

Another sort of concern was expressed by local programs that did not themselves want federal funds but feared the impact of a new federal meals-on-wheels program growing out of the Title VII centers. They assumed—quite rightly, as it turned out—that the two different services would operate under the same guidelines—that meals would be free and that their own "pay if and what you can" principle would not be able to withstand that competition.

As passed by Congress on October 18, 1978, the meals-on-wheels bill was incorporated into amendments to the Older Americans Act that greatly expanded social services for the elderly. Still, NAMP had solid grounds for believing that it was the intent of Congress to expand meal service to the homebound by using local voluntary meals-on-wheels programs as the main vehicle. Many members of the Senate and House authorizing committees said it was, including the chairmen, Senator Thomas Eagleton and Representative John Brademas: "In awarding funds, first consideration must be given to organizations like Meals on Wheels . . ." (Letter, *Washington Star*, July 21, 1978).

Moreover, Congress provided two separate authorizations, one for the existing congregate programs and another for home-delivered meals. This was taken as a signal of congressional intent that meals-on-wheels programs would be eligible for direct grants from the area agencies and not subsumed under the authority of Title VII projects. Finally, NAMP was not only cited in the act as one of the organizations with which the Commissioner on Aging had to consult in setting the qualifications for grants' applicants but also was assured by him that the regulations would specifically protect the local voluntary programs from being forced out of business by Title VII competition.

On July 31, 1979, the draft regulations finally appeared in *The Federal Register*. The key provision states: "The area agency may only award funds for home delivered meals to a service provider that also provides congregate meals [section 1321.147(c)(1)]." This flatly rules out all but a handful of the voluntary meals-on-wheels programs from eligibility for direct federal grants—since, by definition, it is not their purpose to serve congregate meals. It also eliminates the possibility of funding any home-delivered meals services in areas where no congregate meal center exists.

And there is this provision: "The area agency must award funds to a nutrition services provider that (i) Was a nutrition project receiving funds under the former Title VII of the Act on September 30, 1978 [section 1321.141 (b)(2)]." Which is to say that all existing Title VII programs must continue to be funded.

So much for congressional intent and signals, and so much for the commissioner's assurances!

Now, assuming some rationality in the universe and honorable intentions all around, the question has to be, Why? Why these provisions in the regulations? In a July 12, 1979, letter to NAMP, the commissioner on aging justified them as mandated in the statute itself. He cited a clause that says, with respect to nutrition services: "Each project will provide meals in a congregate setting, except that each such project may provide home delivered meals. . . ." Admittedly, this language is susceptible—especially if read in isolation—of the commissioner's interpretation that home-delivered meals may only be provided *in addition to*, rather than *instead of*, meals in a congregate setting. But to give it such an interpretation in the face of the legislative history is to conclude that the Congress actually accomplished the precise opposite of what it intended.

If the Congress fails to challenge AoA on its narrow translation of this ambiguous clause, some questions remain: Will the voluntary meals-on-wheels programs be utilized at all under the new law? And are there any provisions, as promised, to protect those local programs that do not want federal funds from inevitable Title VII competition? AoA says yes: "The nutrition services provider must purchase home delivered meals from an organization, where one exists, that (i) Demonstrates proven ability to provide home-delivered meals effectively and at reasonable costs . . . [section 1321.147(c)(2)]."

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Officials at AoA argue that the intent of this provision is to require Title VII nutrition projects to purchase meals from the voluntary programs. Well, not quite: the wording is such that any organization, even a profit-making catering service, could qualify to provide the meals.

More important by far, reducing the relationship to the terms-and-conditions for "purchasing" meals—as the proposed regulations would—scarcely suggests the partnership that NAMP had in mind. Most of the local programs do a lot more than just provide meals. In addition to screening applicants, the volunteers help their clients establish eligibility for other kinds of assistance, arrange transportation, run errands, write letters, and deliver a host of other services. If participation in the federal program means simply delivering meals, many local groups will want no part of it.

So what future will they have? The experience of Twin Cities Area Meals-on-Wheels of Benton Harbor, Michigan, may be instructive. This four-year-old program used to serve forty homebound people two meals a day, operating at a monthly deficit of $350 (offset by charitable contributions). The program's director said this to me in a letter dated August 9:

> Approximately three months ago we started receiving phone calls from clients saying, "I didn't get my meal." The people who were calling were not in our program. Upon investigation, we found that a duplicate program sponsored by Title VII was developing in the area and many of the clients didn't even know where their meals were coming from. Since that time we have found a gradual decrease in the number of clients who are requiring our services. This decrease has [reduced us] to approximately 20 meals per day and it is prohibitive for us to continue to maintain a half-time person, a telephone, an office and the various other overhead items to maintain a program that only serves 20 meals per day.

Evidently some Title VII congregate programs are already in the home-delivered meals business—and are not purchasing meals from an existing voluntary program. More to the point, however, it seems clear that if the existing meals-on-wheels services choose not to participate in the new federal program—or are not *chosen* to participate—they probably will not make it.

All of which constitutes a sorry reward for local voluntary initiative. Congress apparently did not carefully assess the impact of the language authorizing the new federal program on the existing voluntary effort. And this failure has doubtless been compounded by an outbreak of extreme bureaucratic literalness in construing the statute and writing the regulations. Unless a way can be found to fund the voluntary effort directly, the law and the regulations are likely to have the unintended consequence of destroying the thousands of community-based programs that have been serving the homebound for so long at just about zero cost to the taxpayer.

Given all the congressional accolades and assurances, why did the private meals-on-wheels programs fare so poorly? One reason, surely, is that NAMP, an all-volunteer organization, lacks the funds and lobbying skills to do battle with the federal legislative/regulatory process, whereas the Title VII organization is amply supplied with both.

What is at issue in all this is the nature and purpose of government, and of the federal establishment in particular. It is fair to assume that most Americans continue to believe that the central government's principal responsibility is to undertake great enterprises—to put people on the moon, to protect the nation from its enemies, to establish broad standards of public policy—and that, otherwise, it should do only that which individuals and voluntary groups, localities and states, cannot do as well for themselves. On this assumption, it would seem that policy-makers have an obligation to fashion an approach for getting meals to the homebound that finds room for worthy national purposes, effective local enterprise, and a productive partnership between them. Surely this falls within the range of human ingenuity.

THIS MUCH can be said, however—that the dilemma facing the board of Benton Harbor's meals-on-wheels program left it with only one real alternative. Meeting on September 12—in the month commemorating the twenty-fifth anniversary of meals-on-wheels—the board decided to terminate its program.

How many other voluntary meals-on-wheels services will be run off the road by Title VII competition? With a modicum of good will and good sense, there has to be a better way. ■

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Readings
of particular interest

Regulating Business

The Future of Business Regulation by Murray L. Weidenbaum (New York: Amacom, 1979), 183 pp.

Murray Weidenbaum of Washington University's Center for the Study of American Business observes that a "reversal of the current trend of ever-increasing government intervention in business" is essential to the welfare of the individual citizen. This is so because intervention shows up in higher prices (in effect, a hidden tax on the public), in factories not built, in jobs not created, in goods and services not produced, and in incomes not generated.

The author urges a comprehensive response by the business community. To begin with, corporations must do a better job of what they are in business to do—which is satisfying customers. Critical of the excessive "perks" of many in top corporate management, he advises that compensation be cut back to levels more compatible with the "needs of competitive, profit-maximizing, professional management." Business must also responsibly inform the public on the impact of government intervention, while supporting those regulatory activities that benefit society and opposing those that do not. Further, business must try to alter the environment within which it must operate by involving itself in legitimate ways in the formation of public policy.

So-called public interest groups get a hard look in Weidenbaum's study. He argues that their claim to know what is good for the consumer is supported neither by knowledge of what the public wants nor by any kind of accountability. Moreover, their view that business cares about profits, but not about people, is fundamentally wrong; in fact, business has a powerful interest in improving human welfare because that improvement leads to willing consumers and eventual increases in business profits. Social activists view the business firm as an "instrument for achieving their social objectives" and do not appreciate the long-run consequences of their actions.

Weidenbaum is also critical of media coverage of business and economics. A large percentage of the journalists covering these areas have no understanding of them. Criticism of media coverage (however inept) usually results in cries of interference with the freedom of the press. The author warns reporters to be suspicious of *all* advocates, regardless of kind.

As for academic analysis of business regulation, it is still preoccupied with "old-style" regulation and, for the most part, does not take full enough account of the "expansion in scope and change in character of government regulation of business during the last decade." Theories need to be reworked in the light of these changes. Increased government involvement in the internal decisions of business has created a second managerial revolution, with many traditional responsibilities of corporate management now in the hands of an "immense cadre of government planners, regulators and inspectors." Yet, Weidenbaum concludes, when the contributions of the American business firm to "material welfare and personal freedom are fully assessed," it will win renewed confidence.

Costs of Social Regulation

Benefit-Cost Analyses of Social Regulation: Case Studies from the Council on Wage and Price Stability, edited by James C. Miller III and Bruce Yandle (Washington, D.C.: American Enterprise Institute, 1979), 171 pp.

In their introduction, James Miller of the American Enterprise Institute and Bruce Yandle of Clemson University emphasize that a growing awareness of the link between regulation and inflationary pressures has accompanied the recent growth in the new health, safety, and en-

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vironment regulation. Thus, in 1974, when the Council on Wage and Price Stability was created and charged with reviewing federal programs to learn if they had any inflationary impact, the council determined that benefit/cost analyses of important regulations were indispensable to its task. This volume is an anthology of twelve case studies edited from formal CWPS filings in regulatory proceedings during the years 1974–76, including these examples.

The opening section on consumer and worker health includes an analysis by John F. Morrall III, deputy assistant director of CWPS, of the Occupational Safety and Health Administration's proposal for noise abatement in the work place. Comparing OSHA's proposal for a uniform decibel standard (achieved through "engineering controls" to reduce the noise reaching the worker) with standards varying by industry (achieved through personnel protective devices), he concludes that cost-effectiveness analysis dictates the latter approach. At the time of publication, a final standard on work-place noise had yet to be promulgated.

In the section on product safety, Thomas D. Hopkins of CWPS and Gerald G. Treadgill of the United States Army address the National Highway Traffic Safety Administration's proposal to require that cars be equipped with "passive" (automatic) passenger protection—in most cases, air bags. Their report contended that the air-bag device was in its infancy, that its benefits were uncertain, that its industry-wide impact was potentially inflationary, and that (government-backed) tests in real-world car fleets were needed. Their conclusion: given that seat-belt restraint systems are "extremely effective in reducing death and injury when used, passage of mandatory seat-belt laws, hard-line advertising campaigns, and improved design . . . could eliminate the need for much more costly passive restraint systems." The editors point out that, in 1977, the Department of Transportation announced a performance standard that mandates a phasing-in of passive restraints (including air bags in some instances).

Highlighting the section on energy, the environment, and international trade is a study of motorcycle emissions standards by Roger J. Mallet, now at the Department of Commerce. The Environmental Protection Agency's proposal called for rigorous permanent standards subjecting all on-road motorcycles to uniform emission controls. But the proposal's benefits would be limited and its costs excessive, argued Mallet, citing three central findings: motorcycle emissions are not a serious source of the nation's air pollution, the standards proposed (in contrast to those for automobiles) would not be cost-effective, and demand would be shifted to the unregulated off-road motorcycles. The author suggested that if EPA considered action necessary for the "public health, it should pursue control of only those types of motorcycles for which regulation is as efficient as that applied to other sources of air pollution." Subsequently, the editors report, EPA implemented standards significantly less severe than those originally proposed.

Miller and Yandle draw three conclusions from their case studies. One is that legislation frequently limits the extent to which benefit-cost analysis is utilized when formulating regulations. Second, "agencies develop considerable momentum and tend to reflect the views of the constituents that supported their formation." Finally, economic analysis of the sort contained in the volume can still be a useful tool for evaluating the performance of regulatory agencies.

Assessing Oil Import Quotas

Limiting Oil Imports: An Economic History and Analysis by Douglas R. Bohi and Milton Russell (Baltimore: Johns Hopkins University Press for Resources for the Future, 1978), 356 pp.

In 1959, after voluntary restraints failed to limit oil imports, President Eisenhower established a Mandatory Oil Import Program (MOIP). The program was set up in the belief that everincreasing levels of oil imports threatened national security, eventually held imports to 12.2 percent of domestic production, and was terminated in 1973. Douglas Bohi and Milton Russell of Resources for the Future analyze experience under this program.

As the authors point out, the imposition of import controls in the United States raises the value of U.S. oil above the world market level (since there is not enough U.S. oil to fill U.S. needs without imports) and this extra scarcity value accrues to owners of the "right" to import oil. If importers receive import licenses at no cost, they gain this scarcity value (are paid for

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helping to make up the shortage); if they are forced to pay for the licenses, the Treasury gains. But the generic issues of import limitation remain the same in either case.

Bohi and Russell show initially how the enormous sums involved aroused economic interests and how the government responded to pressures from these interests. Changes in the program over its life reflect the relative strength of some of the politically active interest groups: residual fuel oil imports into the Northeast were decontrolled; major oil companies that had been the historic importers lost quota shares; special treatment was accorded Canadian, Mexican, and Venezuelan imports; small refiners received proportionately greater quota allocations than large refiners; allocations were granted to refiners locating in Puerto Rico and the Virgin Islands (ostensibly to encourage economic development there); petrochemical firms were added to the list of allowed importers; asphalt was decontrolled to assist highway construction; and in special cases imports of low-sulfur fuel oils were allowed to aid compliance with air-pollution standards.

The study demonstrates that the mandatory import program changed the petroleum industry in unplanned and unanticipated ways that eventually became troublesome. For example, the provisions of the program discouraged investment in domestic refinery capacity, and changed the type, location, and output mix of refineries from what it would otherwise have been. Because of supply uncertainties and because of the incentive to use limited allocations for more valuable crude oil and product imports, refineries capable of using the more abundant high-sulfur foreign crude were not built. Because of import allocations, some of the refineries that were built came to be located along the border with Canada and in the Caribbean. Finally, because the program favored residual fuel oil, northeastern consumers and electric utilities increased their dependence on oil, often in preference to coal.

Turning to an economic analysis of oil import limitation, Bohi and Russell show how the economy must bear the cost of the inefficiencies (indirect costs) created by the quota program and how consumers, in addition, must pay increased prices (direct costs) because of scarcity. The authors estimate the direct costs to consumers at over $43 billion from 1960 to 1970 and note that, with indirect costs added, the bill increases substantially. They also estimate that about 40 percent of the extra oil revenues went to cover the resource costs of U.S. crude oil producers (whom the program protected from foreign imports), another 40 percent went to profits of producers, and 20 percent went to refiners.

Against these costs, the authors balance the benefits of the program. They estimate that, without quotas, the United States would have been importing over 60 percent of its oil consumption by 1970 instead of only 14.6 percent. The domestic industry was larger and the domestic price higher as a result of quotas, and the 1973 shock from tighter oil supplies and rising prices was consequently reduced.

The book also analyzes alternative ways of achieving the quota program's goals, including tariffs, subsidies, consumption taxes, strategic storage, and shut-in capacity. A tariff system would have been cheaper than a quota, and could have avoided many of its arbitrary, discriminatory, and rigid features. The authors warn against a resumption of import controls in the current energy environment: "Once quantitative import controls are instituted . . . the nation will be forced to choose an even more fully planned energy sector or else make a break with the previous quarter-century and attempt to institute a market system." Bohi and Russell are not sanguine about that break's being made.

The Economics of Antitrust

"Symposium on Antitrust Law and Economics" in *University of Pennsylvania Law Review*, vol. 127 (April 1979), pp. 918-1140.

These six articles were originally presented at a 1978 conference on antitrust law and economics held at the University of Pennsylvania. In the first article, Richard Posner of the University of Chicago Law School focuses on differences between the Chicago and Harvard schools of antitrust analysis. Crediting the origin of the Chicago school to the work of Aaron Director, he attributes the key differences in the Chicago and Harvard approaches to Director's insistence that antitrust issues be studied "through the lens of price theory."

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Specific areas in which the two schools have differed include the motives for and consequences of tie-ins and vertical integration and other forms of vertical restrictions (such as resale price maintenance), the risks to a competitive economy from predatory price cutting, and the significance of advertising as a possible "barrier to entry." Posner notes, however, a growing convergence of the two schools. Differences apparently remain on the causes and consequences of concentration and on the attractiveness of deconcentration without regard to the traditional burden of proving liability. But even here, Posner finds that the defections from the Harvard school are on the increase.

Federal Trade Commissioner Robert Pitofsky, in a paper prepared before his appointment, argues that it is "bad history, bad policy, and bad law to exclude certain non-economic considerations" from the enforcement of antitrust. The goal of dispersed power is one that Americans value in both public and private sectors. This is evident from the legislative history of various antitrust enactments, the Hart-Scott-Rodino Antitrust Improvements Act of 1976 being the most recent example. According to Pitofsky, "elimination or containment of monopoly, elimination of unnecessary barriers to entry, and unreasonable business practices not only promote economic efficiency but tend to avoid undue concentrations of economic power." Still, tensions remain. Lest antitrust resources be dissipated, greater effort is needed to distinguish those cases in which the political content is especially great from those in which efficiency considerations mainly govern.

Oliver Williamson of the University of Pennsylvania examines various types of vertical restrictions (primarily vertical integration and vertical customer or territorial allocation) from the transaction-cost approach developed in his earlier writings. The paper critically examines both the efficiency gains, if any, arising from vertical restraints and the strategic purposes and (possibly) the anti-competitive effects that may accompany such restraints. The basic proposition is that vertical restraints are efficiency-enhancing unless certain structural conditions exist within the industry. Williamson argues that failure to make express allowances for transaction-cost considerations has been responsible for mistaken public policy, most notably in having made certain types of franchise restrictions illegal (until overturned by a recent Supreme Court decision). He discusses the legal principles derivable from the transaction-cost approach and finds that the recent Supreme Court decision in *Continental T.V. Inc.* v. *GTE Sylvania Inc.* [which used economic criteria to rule that Sylvania did not violate antitrust laws by spacing franchisers in order to limit competition among them] is on sounder economic ground than the previous precedent.

Phillip Areeda and Donald Turner of Harvard Law School examine the claims of extended interdependence and of effects on interindustry competition as grounds for condemning conglomerate mergers. They define a set of minimum conditions that must be satisfied before extended interdependence can be considered anticompetitive. Included among these are: (1) the merged firm and at least one rival must confront each other in at least two oligopolistic markets, (2) the merged firm and at least one other two-market firm must be significant in both markets, and (3) the merger must create a possibility for competitive retaliation in markets where such possibility did not previously exist.

Interindustry mergers have substantial anticompetitive effects only under very special and highly unlikely circumstances—that is, if both industries are noncompetitive and if the merging firms are dominant and have similar interests in both markets. Areeda and Turner suggest that if conglomerate mergers are to be banned, it is for a reason that has nothing to do with anticompetitive effects.

Richard Schmalensee of MIT considers the economics of the Federal Trade Commission's initial decision in *Borden, Inc.*, and points to the need for more sophisticated economic analysis than rudimentary models commonly provide. In particular, Schmalensee examines whether Borden's attempts to recover lost market share in the market for reconstituted lemon juice should be characterized as predatory conduct. In answering that question, he explores the utility of standard predatory-pricing models and market-definition criteria, concluding that conventional market-share measurements are poorly suited to deal with differentiated product markets. Schmalensee does not become engrossed in efforts to devise refined market-share measurements. Rather he

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counsels that attention be focused on whether the purported predator enjoyed monopoly advantage and hence had an incentive to engage in predation. He finds fault with many of the proposed straightforward tests for predation but is equally concerned that judicial attempts to use an ad hoc "rule of reason" approach will on balance inhibit competition. He suggests coupling any such approach with a strong presumption of innocence.

University of Wisconsin economist Leonard Weiss summarizes the literature in the concentration-profitability controversy and contrasts the views of George Stigler and J. S. Bain on the antitrust significance of entry barriers. Bain's concepts (with which Weiss agrees) are then applied to the facts in the government's massive monopolization case against IBM. What emerges are the possibilities that history matters in the evolution of an industry, that unassisted market processes may not reliably undo evolved dominant-firm outcomes within a reasonable time period, and that strategic behavior—current behavior to achieve a future purpose—has to be a subject of enforcement attention. These possibilities lead Weiss to conclude that, within limits, dissolution of dominant firms could be justified without any requirement for anticompetitive conduct, so long as the dominant position is not shown to be justified by scale economies or valid patents.

The Beleaguered Corporation

In Defense of the Corporation by Robert Hessen (Stanford, California: Hoover Institution Press, 1979), 133 pp.

The attack on the American corporation comes from individuals as diverse as Irving Kristol and John Kenneth Galbraith. Especially serious, in the view of historian Robert Hessen of the Hoover Institution, is the attack made by Ralph Nader. This book is a response to Nader and, in particular, to Nader's proposal for federal chartering of every U.S. corporation whose sales exceed $250 million or employees number more than 10,000.

The framework for the Nader proposal is the concession theory—which holds that corporations are creatures of the state. The theory had its origin in medieval England after the Norman conquest, when existing land titles were abrogated and all land became the property of William the Conqueror; and the theory survives even though, Hessen argues, voluntary business enterprise or investment for profit bear no relation to medieval corporations.

In the sixteenth and seventeenth centuries, the grant of a charter carried with it the promise to serve the King. This outdated notion, in Hessen's view, is the basis for Nader's belief that the corporation must serve the public interest. Nader argues that, through the corporation charter, the corporation receives special privileges that cement its position as creature of the state. The privileges Nader lists are entity status, limited liability, and perpetual life. According to Hessen, these privileges can and should be viewed as contractual. Perpetual life does not ensure continued existence: one-half of all corporate ventures fail in the first five years. Limited liability is the result of a contract between owners and creditors which creditors cannot be compelled to accept. Entity status—the ability to sue and be sued as a unit—is a legal convenience for the benefit of the corporation and those who would challenge it and is not limited to corporations.

Nader holds up the ideal of corporate democracy, a system in which shareholders actively participate in decision-making. But Hessen argues that most shareholders do not desire to play such a role, that what they seek is a sideline investment, one that enables them to entrust their savings to the managerial expertise of professional managers in return for a share in the resulting profits. Their primary safeguard if they are dissatisfied, according to Hessen, is their ability to sell their shares almost instantly. He views the stock market as a daily plebiscite in which shareholders are continually registering their approvals and disapprovals.

The danger of the Nader proposal, says Hessen, is that it is a foot in the door for eventual federal control of all business activity. Nowhere does Nader discuss his reasons for his $250 million limitation, a limit which could make federal chartering applicable to numerous nonincorporated or nonprofit—yet equally powerful—organizations.

In conclusion, Hessen writes:

> A proper defense of corporations must stress that they are created and sustained

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by freedom of association and contract, that the source of freedom is not governmental permission but individual rights, and that these rights are not suddenly forfeited when a business grows beyond some arbitrarily defined size, either in terms of assets, sales, and profits or the number of investors, employees, and customers.

The Natural Monopoly Problem

The Control of Natural Monopolies by Richard Schmalensee (Lexington, Mass.: Lexington Books, 1979), 178 pp.

A natural monopoly (an industry in which "production is most efficiently done by a single firm") may—like any other monoply—be able to set its prices well above its costs and therefore enrich itself at the expense of society. That this happens forms the basis of the argument for regulating natural monopolies. Economist Richard Schmalensee of MIT argues here that natural monopoly regulation should focus on economic (allocative) efficiency. If it does so, it will reduce the problem of excessive profits, but if it focuses only on the latter, it may not improve efficiency.

According to Schmalensee, this view of the problem has two important policy implications: (1) experts—in this case, economists—should have a strong influence over the actual regulating of natural monopolies and (2) relevant legislation should embody the objective of economic efficiency, an objective both feasible and appropriate to the social issue a natural monopoly poses. If those responsible for regulating monopoly are encouraged to have goals other than economic efficiency, the absence of a clear standard or clear priorities makes administrative or judicial review almost impossible. The "ambiguity makes it more likely that decisions will reflect the values and objectives of the administrators involved or those of special interests" instead of the public interest.

In this study, Schmalensee examines various ways of controlling natural monopolies and evaluates them from the standpoint of economic efficiency. Whereas most studies compare actual regulatory situations with some ideal, it is urged here that research focus on alternate—although imperfect—forms of control, where the real choices lie.

Among the alternatives examined are those that would make use of markets for capital funds and for managerial talent: for example, (1) franchise bidding for natural monopoly positions (in which the firm that offers to supply services at the lowest price wins the bid to be the natural monopolist forever), and (2) proposals that rely on the market for managerial talent (the managerial team that could supply services at the lowest cost would win a franchise to operate assets owned by the public authority). He finds that the evidence provided in analyses of these approaches is not encouraging. "The markets for capital and management simply cannot adequately perform the control function unaided." State or municipal ownership is another strategy Schmalensee explores. Used in the cases of electric utilities and water supply systems, this method appears to be more suitable for the latter, but the author notes that there is insufficient evidence from which to generalize about the effectiveness of different forms of public ownership.

Next he considers methods of reform that might make regulation more responsive to economic changes. Excess profits taxation, according to most current studies, is as complex and difficult as deciding a fair rate of return on capital under conventional regulation—and therefore creates the same undesirable economic rigidities. Relaxing entry restrictions and using clauses that permit automatic adjustments to increased costs are other, more attractive proposals.

Regulatory commissions can improve economic efficiency by, for example, basing prices on marginal costs or using automatic adjustment clauses that have the effect of balancing sensitivity to change in economic conditions with productive efficiency. Schmalensee points out that it is not possible (or desirable) to eliminate all commission discretion, and he therefore makes a distinction between having regulators adopt these approaches and writing the approaches into the control institution from the beginning. He urges recognition of the existence of alternative strategies for control of natural monopolies and calls upon analysts to shift from comparing ideal situations to examining the actual, less-than-perfect possibilities in attempting to reform control institutions or design new ones.

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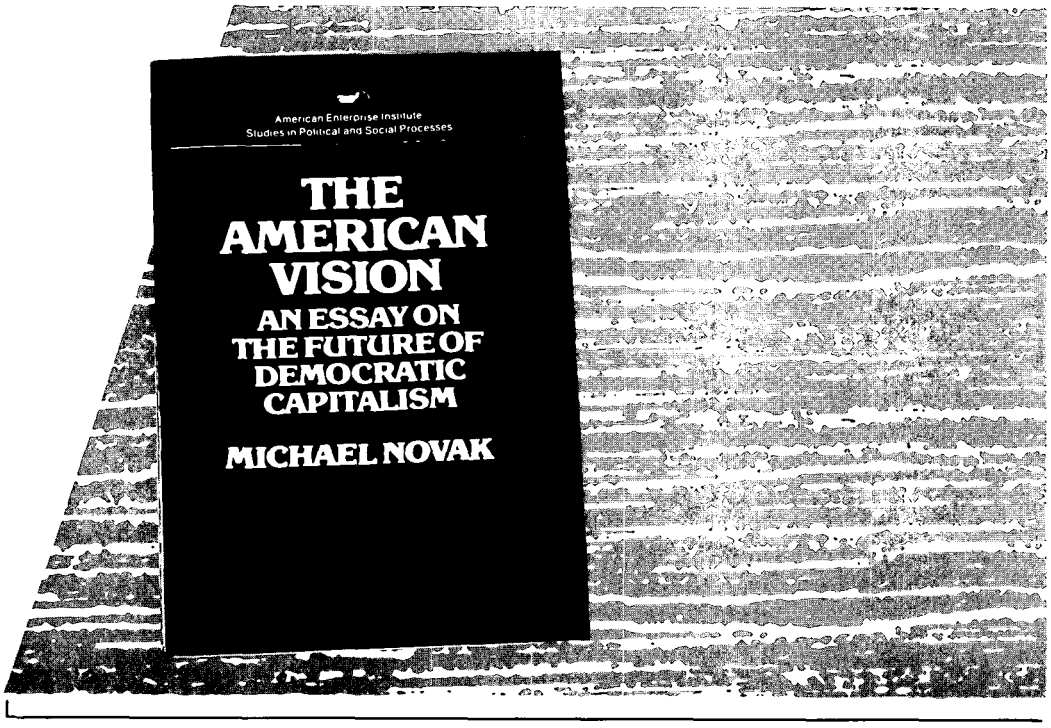
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